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Why the economic case for a multilateral agreement on investment is weak

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**Why the Economic Case for a Multilateral
Agreement on Investment is Weak**

by

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revised

May 2003

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Preface

This paper reports work which is part of the EU-India Network on Trade and Development. The project is run by the Consumer Unity & Trust Society (CUTS), Jaipur (India), and the University of Sussex. We would like to thank the participants of the Midterm Review Meeting in Jaipur on December 20–21, 2002 for constructive criticism. We are particularly indebted to our discussant T.N. Srinivasan and to Alan Winters for many helpful suggestions. Thanks are also due to Rolf J. Langhammer and several anonymous referees for comments on the second draft of this paper. Manoranjan Pattanayak provided research assistance.

According to the terms of reference for the Investment Group of the above mentioned project, we focus on the pros and cons of a multilateral framework for cross-border investment activity. The rise of bilateral investment treaties as well as previous attempts to reach international agreements on investment issues provide the starting points of this discussion. The major aim is to assess what a multilateral framework may offer in addition to bilateral and plurilateral rules. More specifically, the terms of reference consider the following issues to be of major relevance:

- the extent to which a multilateral framework would increase transparency and reduce transaction costs;
- the opportunity costs and trade-offs to which a multilateral framework may give rise;
- the possible effects on the quantity of FDI flows to participating countries;
- the request of developing countries for a balanced agreement, including corporate obligations and allowing for flexibility and privileged status of developing host countries, in order to improve the “quality” of FDI;
- the economic justification of performance requirements which may turn out to be a particularly contentious issue in negotiations on a framework for investment;
- and the prospects for a multilateral framework to prevent the widely feared “race to the top” with regard to FDI incentives.

Even though this list covers a fairly broad spectrum of questions, two major limitations of our analysis should be mentioned at the outset. First, we discuss the pros and cons of a multilateral investment agreement, rather than the effects of capital flows in recipient countries. In particular, it is beyond the scope of this paper to carefully assess the benefits developing countries may derive from inflows of FDI. We do note, however, that the relevant literature suggests that favorable growth effects of FDI in developing countries cannot be taken for granted (which is in some contrast to the currently prevailing euphoria about FDI among policymakers).

Second, the main body of the paper is confined to negotiation issues that are strictly related to cross-border investment, notably FDI. This discussion leads us to conclude that the *economic* case for a multilateral agreement is weaker than its proponents suggest. We are well aware that the *political* case for such an agreement may be stronger once linkages between narrowly defined investment issues and various trade and labor issues are taken into account. As a matter of fact, in the concluding section, we suggest that developing countries should consider cross-issue linkages in WTO negotiations and the option to enter into a “grand bargain”. The position we take has been criticized from opposite angles by several referees:

- On the one hand, the suggestion for a grand bargain is dismissed as irrelevant, not worth considering, or inconsistent with the economic arguments against a multilateral investment agreement.
- On the other hand, a broader discussion of the merits of cross-issue linkages is called for as the fragmentation of production makes trade and investment closely intertwined.

We principally accept the second critique, which logically implies that the first critique is misplaced. Nevertheless, we decided not to enter more deeply into the merits and possible drawbacks of cross-issue linkages. As economists not being involved in WTO negotiations, we lack comparative advantage to analyze which specific effects investment-related concessions by developing countries may have on the negotiation stance of industrialized countries in various areas of immediate interest to developing countries, including agriculture, barriers against imports from poor countries and anti-dumping rules. If at all, the reaction patterns may be identified in the process of WTO negotiations. We would like to maintain, however, that our economic analysis suggests that developing countries could make investment-related concessions from which they have little to lose, while industrialized countries seem to care for them and may, thus, be more inclined to offer *pro quo*-concessions.

1 Why Foreign Direct Investment Is on the Agenda of Policymakers

Especially since recent financial crises in Asia and Latin America, developing and newly industrializing countries have been strongly advised to rely primarily on foreign direct investment (FDI), in order to supplement national savings by capital inflows and promote economic development. Even harsh critics of rash and comprehensive capital account liberalization argue in favor of opening up towards FDI (e.g., Stiglitz 2000). It is for several reasons that developing countries may benefit from FDI inflows:

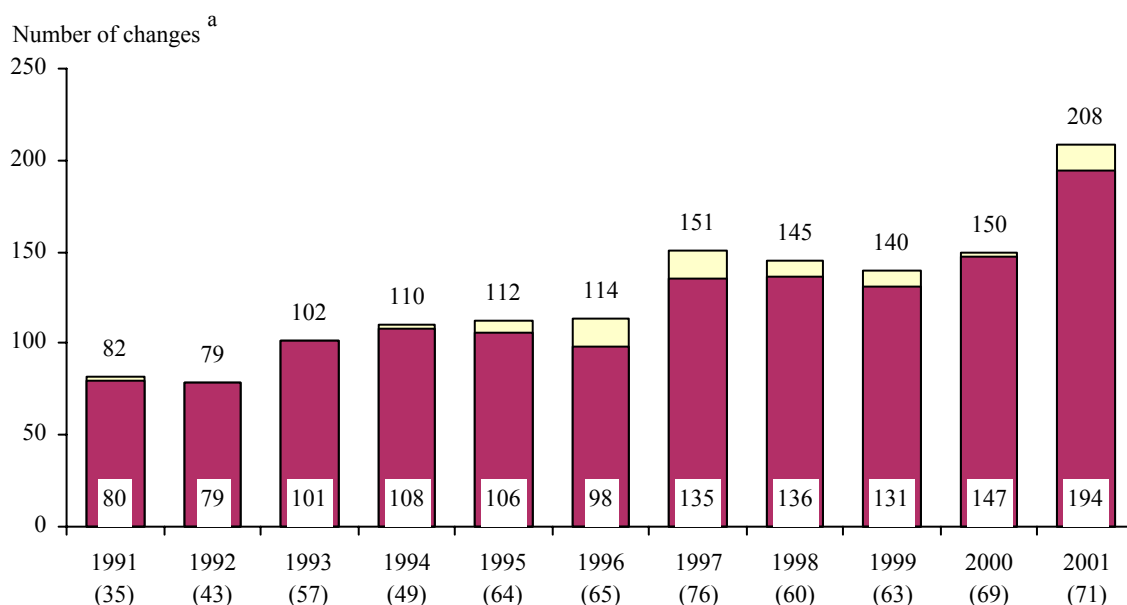
- Foreign direct investors typically have a longer-term perspective when engaging in a host country. As a consequence, FDI is less volatile and less prone to crisis than other private capital flows (Nunnenkamp 2001a: Figure 9).
- In contrast to debt inflows constituting contractually fixed debt-service obligations, FDI constitutes a residual claim on the host country's resources. In other words, FDI has risk-sharing properties.
- While debt-related capital inflows may be used for consumption, FDI is more likely to add to domestic investment. Yet, overall investment may remain unaffected by FDI inflows, especially if they come in the form of mergers and acquisitions (M&As).
- FDI is more than just capital; it also offers access to internationally available technologies and management know-how. Firms and workers in the host country may benefit from economic spillovers so that productivity increases are not restricted to foreign-dominated operations.

For all these reasons, it is widely expected that FDI provides a stronger stimulus to economic growth in the host countries than other types of capital inflows. Recent empirical studies on the FDI-growth link do provide some support to this proposition (e.g., Soto 2000). However, the available evidence also suggests a major qualification when it comes to the productivity-increasing effects of FDI in developing countries.¹ In one way or another, recent studies echo an earlier finding of Blomström et al. (1994), namely that the positive impact of FDI on economic growth is confined to higher-income developing countries. As it seems, developing countries must have reached a minimum level of economic and institutional development before they can capture the growth-enhancing effects of FDI.

Nevertheless, more and more developing countries have entered the worldwide competition for FDI. This trend is clearly reflected in an almost universal move to liberalize national FDI regulations (Figure 1). In 1991–2001, about 95 percent of all changes in national FDI regimes, reported by UNCTAD (2002: 7), were meant to treat FDI more favorably. Liberalization measures or measures aimed at strengthening the functioning of markets as well as increased FDI incentives are included in this category.² By contrast, just 78 out of almost 1400 measures taken in 1991–2001 intensified control over FDI or reduced FDI incentives.

The World Bank (2003: 118) reckons: “As with trade reforms, unilateral reforms to liberalize foreign direct investment (FDI) are likely to have the greatest and most direct benefit for the reforming country.” Apart from unilateral liberalization measures, various countries have concluded bilateral investment treaties (BITs) for the protection and promotion of FDI. The number of BITs increased significantly to 2099 at the end of 2001. As it seems, both the liberalization of FDI regulations and the protection of foreign investors against political risk is fairly advanced. Hence, the obvious question arises why a multilateral agreement on investment may be needed.

Figure 1: Number of Changes in National FDI Regulations 1991–2001



^aShaded area: changes considered more favorable to FDI; figures in brackets below years refer to the number of countries that introduced changes in their FDI regime.

Source: UNCTAD (2002: 7).

According to the Doha WTO Ministerial Declaration, the purpose of a new multilateral framework on investment is “to secure transparent, stable, and predictable conditions for long-term cross-border investment” (WTO 2001: Paragraph 20). From this statement, one may conclude that the basic WTO rationale of the benefits of rule-making in international economic relations does not only apply to trade but also to cross-border investment. However, trade and capital flows differ in several respects. Stanley Fischer, even though a prominent supporter of free international capital flows, acknowledges that “the difference between the analytical understanding of capital versus current-account restrictions is striking. The economics profession knows a great deal about current-account liberalization, its desirability, and effective ways of liberalizing. It knows far less about capital-account liberalization” (Fischer 1998: 8). Empirical research, too, suggests that the case for multilateral rule-making is stronger for trade than for investment. While “openness to trade has unambiguously helped the representative Third World economy” (Lindert and Williamson as quoted in World Bank 2002: 5), empirical studies reveal ambiguous effects of capital inflows in developing countries, even in the case of FDI. Furthermore, an investment agreement is inherently different from a trade agreement in that developing countries are, almost invariably, net receivers of FDI, whereas industrialized countries are both important receivers and senders of FDI.³ Consequently, conflicts of interest and bargaining asymmetries tend to be more pronounced when it comes to an investment agreement.

In the remainder of this introductory section, we present the major arguments of the proponents and opponents of a multilateral agreement on investment. These arguments will be taken up and analyzed in more detail in the subsequent sections. In doing so, we will not apply a strict definition of

“investment”. The existing regulatory environment, including BITs and investment-related agreements on a plurilateral level, covers different types of foreign investment, with some agreements extending far beyond FDI. However, our discussion will focus on FDI, since it is mainly the rise of FDI that is widely expected to help developing countries foster their economic development.

Contentious issues related to a multilateral agreement on investment center around four questions: Is there any need for such an agreement? What should it contain? Should binding rules, or rather flexible guidelines be aimed at? What would be the likely effects on the quantity and quality of FDI? Many developing countries are opposed to a multilateral agreement on investment, while its proponents are mainly to be found in industrialized countries. Likewise, disagreement is mainly between developing and industrialized countries when it comes to the contents and character of a multilateral framework. However, interests differ also within these groups, and independent experts provide different answers to these questions.

As concerns the need for a multilateral agreement, opponents point out that the liberalization of FDI regulations has progressed rapidly through unilateral, bilateral and plurilateral initiatives. The accompanying boom of FDI is said to reveal the irrelevance of a multilateral framework. By contrast, proponents conjecture multilateral negotiations on investment to be instrumental to greater openness of investment regimes than can be achieved unilaterally. They also argue that it is precisely because of the proliferation of BITs and plurilateral rules that a multilateral agreement is required. This proliferation is deemed unwarranted, since the complexity and intransparency of FDI regulations is increased, rather than reduced in this way. If a multilateral agreement were to become “a 'one-stop' substitute for the complex and legally divergent web of existing BITs” (World Bank 2003: 127), this would not only improve transparency. According to the proponents of a multilateral agreement, this could also help counterbalance the bargaining asymmetries built into BITs and regional agreements. For example, it might become easier for developing countries to prevent non-investment matters such as labor and environmental standards from being included in agreements on investment. However, many developing countries appear to be reluctant to buy the argument that their bargaining power would be stronger in a multilateral context than in their bilateral dealings with major industrialized countries.

The proponents in industrialized countries suggest that the contents of a multilateral agreement should be similar to what was discussed during the failed attempt at the Multilateral Agreement on Investment (MAI) among OECD countries in the 1990s (for details, see Section 4 below). This implies that the focus would be on guarantees for foreign investors related to entry and post-entry conditions. Developing countries are opposed to this approach which they regard as biased towards the interests of foreign investors. If a multilateral agreement is not plainly rejected, developing countries ask for a balanced agreement which, according to their view, should include obligations of foreign investors.

Whether rules should be binding or flexible is debated on different levels. Most fundamentally, skeptics doubt whether it is, theoretically and empirically, feasible to apply to investment the principle of free movement as applied to goods and services. Unlike goods and services, investment is considered an ill defined entity and a reflection of imperfect international markets for technology. It is pointed out that the activities of foreign investors are highly diverse, involving operation, maintenance, use, sale or liquidation of an investment. More practically, it is disputed what exactly should be binding. Developing countries are pressing for binding rules on corporate behavior, but are reluctant to tie their own hands. Not surprisingly, the business community in industrialized countries favors exactly the opposite: Binding commitments by host countries are considered necessary in order to lock in unilateral reforms and provide additional protection of investors' rights.

As concerns possible effects of a multilateral agreement, developing countries are mainly concerned about the quality of FDI. In other words, they want to ensure, e.g. through corporate obligations, that FDI fosters economic development in the host country. On the other hand, the business sector in industrialized countries is striving for an agreement which would expand investment opportunities in potential host countries. As will be argued below, the effects of a multilateral agreement on both, the quality and quantity of FDI may easily be exaggerated.

Against this backdrop, we proceed by presenting the basic characteristics of BITs and discussing possible shortcomings in Section 2. Subsequently, we review plurilateral arrangements related to the

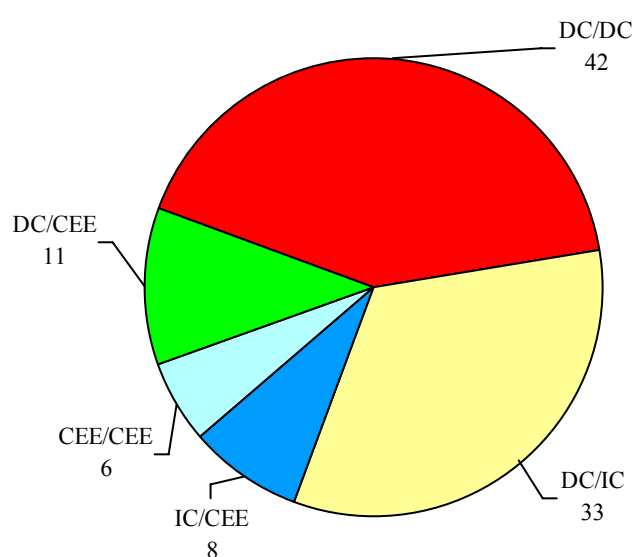
treatment of FDI in regional trade agreements (RTAs) (Section 3). This leads to the question of what a multilateral agreement on investment may offer in addition to existing agreements. The failure in the late 1990s to conclude the MAI among OECD countries provides the starting point for addressing this question (Section 4). Next, we discuss whether and why another attempt to agree on a multilateral framework should be undertaken (Section 5). Major issues related to such an agreement such as performance requirements (Section 6) and incentives competition (Section 7) are analyzed in more detail. Section 8 summarizes and discusses strategic options of developing countries of how to proceed in investment-related multilateral negotiations.

2 Bilateral Investment Treaties

Apart from unilateral regulatory changes, the desire of governments to facilitate FDI flows is also reflected in a dramatic increase in the number of BITs for the protection and promotion of FDI during the 1990s (UNCTAD 1997: 19). Less than 400 BITs were reported at the beginning of the 1990s, more than 80 percent of which involved at least one developed country as a partner. The number of BITs soared to 2099 at the end of 2001.

The proliferation of BITs can at least partly be attributed to the absence of a multilateral framework on investment. Yet, it is open to question whether this trend can be reversed by including investment in the Doha agenda (see also Section 5 below). Many developing countries are opposed to binding multilateral investment rules, despite the argument that their bargaining position would become stronger in a multilateral context. As a matter of fact, the proliferation of BITs is largely because developing countries were eager to conclude BITs, either with developed countries or among themselves. In 2001, 86 percent of the 158 BITs concluded involved at least one developing partner country (Figure 2). Moreover, the largest share of BITs concluded in 2001 were an intra-developing country affair. It should also be noted that BIT activity was not restricted to relatively advanced developing countries, but involved various least developed countries as well. In 2001, a number of 23 least developed countries concluded 51 BITs, 13 of which least developed countries signed among themselves.

Figure 2: BITs Concluded in 2001 by Country Group^a (percent)



^aDC= developing countries; IC = developed countries; CEE = Central and Eastern European countries.

Source: UNCTAD (2002: 8).

As mentioned before, BITs are considered a means to facilitate FDI flows and to provide foreign investors with a clear legal framework, in order to reduce uncertainty related to the treatment of FDI in potential host countries before and after entry. However, reducing legal uncertainty by concluding a large number of BITs may come at a cost for foreign investors. An ever increasing number of BITs tends to reduce transparency and may render it difficult for foreign investors, notably relatively small enterprises engaging in FDI, to collect and evaluate the relevant information. Transaction costs related to FDI can, thus, be expected to rise with the number of BITs.

Consider the case of a German investor who wants to outsource relatively labor-intensive parts of his production to a developing country. Apart from evaluating economic fundamentals in potential developing host countries, the investor will have to study various BITs and compare the legal framework laid out there. As of January 2000, Germany had signed 124 BITs, more than any other country at that time (UNCTAD 2000b: 9); 102 BITs had been concluded with developing countries. Even if the investor had shortlisted some developing countries on the basis of economic fundamentals, information costs might still be substantial when it comes to evaluating the relevant BITs.

Information costs and transparency do not only depend on the number of BITs. Actually, lack of transparency would be a minor problem, if legal and administrative procedures and regulations were the same in all BITs signed by one particular country. This is not the case, however, even though most BITs do have common features (see Box 1). There is considerable uniformity in various principles, but specific formulations vary. Furthermore, some BITs go beyond the principles noted in Box 1. This is particularly in two respects. First, most BITs do not grant the right of establishment to foreign investors, whereas some BITs provide a guarantee of national and MFN treatment on entry and establishment. Second, some BITs prohibit performance requirements with regard to local content, exports and employment, as conditions for the entry or operation of foreign investors.

Box 1

Important Similarities between BITs^a

- Broad and open-ended definition of foreign investment.
- Entry and establishment subject to national laws and regulations.
- Fair and equitable treatment of foreign investors.
- Principle of national treatment of foreign investors, but often subject to qualifications and exceptions.
- MFN treatment, subject to some standardized exceptions.
- Right of the host country to expropriate foreign investors, subject to the condition that expropriation is non-discriminatory and accompanied by compensation.
- Guarantee of free transfer of payments related to a foreign investment, often qualified by exceptions in case of balance-of-payments problems.
- State-to-state dispute-settlement provisions; investor-to-state dispute settlement becoming standard practice.

^aFor a more detailed presentation, see UNCTAD (1998a: 100) and CUTS (2001: 8 f.).

From the perspective of foreign investors, the limitations of BITs are primarily related to transaction costs. In addition to the sheer number of BITs with different regulations and procedures, the reduction in non-economic risk through BITs is sometimes considered insufficient. Major shortcomings of most BITs are seen in lacking protection against violations of intellectual property rights, and in discretionary interventions by sub-national authorities of host countries that are not prevented by BITs.

Developing host countries, too, are concerned about shortcomings of BITs. This may be surprising since, as mentioned before, developing countries were signatories of most of the recently concluded BITs. As it seems, developing countries faced a dilemma: They entered into BITs in order to improve their chances to attract FDI, even though the bargaining position of an individual host country,

especially if it was small, vis-à-vis foreign investors and their home countries was too weak to have a say on the exact terms of BITs.⁴ Hence, developing countries frequently complain that BITs are biased in that host countries (have to) agree to binding obligations in various respects, whereas foreign investors benefit from rights without assuming any duties. For example, BITs typically do not include provisions against restrictive business practices; they do not define basic labor standards to which foreign investors shall adhere; and they do not address the issue of binding obligations of foreign investors with regard to social responsibilities and transfers of technology.

Coordination among developing countries may offer a way to strengthen their bargaining position in dealing with foreign investors and their governments. However, as shown below, the widely perceived bias of rights and duties in favor of foreign investors is also underlying the reservation of many developing countries to enter into negotiations on a multilateral framework on cross-border investment issues (Kumar 2001; Singh 2001). Moreover, it is open to question whether FDI would offer more benefits to developing host countries, if investment agreements were to include binding commitments of foreign investors. On the one hand, the “quality” of realized FDI projects may improve, if agreements ensure that FDI helps achieve development objectives of host countries. On the other hand, strict requirements imposed on foreign investors may have as a consequence that the amount of FDI flowing to developing countries declines. Foreign investors always have the option not to undertake FDI projects under conditions they consider unprofitable. The severity of this trade-off depends on whether or not investment agreements can reasonably be expected to induce more FDI.

The experience with BITs suggests that the amount of FDI flowing to developing countries is largely determined by factors other than investment agreements. UNCTAD (1998a: 117) argues that “it would be unreasonable to expect that any improvements in the investment climate brought about by BITs, which relate only to parts of the FDI policy framework, could exert a significant impact on FDI flows.” Several empirical analyses confirm the relative insignificance of BITs in determining FDI:

- UNCTAD (1998b) analyzed time-series data on bilateral FDI flows between the signatory countries of a BIT. It was shown that the host country’s share in the outward FDI of the home country increased only marginally after the signing of a BIT. This suggests that BITs do not cause significant diversion of FDI from host countries not being part of the agreement to host countries being signatories of BITs.
- Hallward and Driemeier, the results of whom are summarized in World Bank (2003: Box 4.4), compared FDI flows in the three years after a BIT was signed to those in the three years before. No significant increase in FDI was found.
- When analyzing FDI determinants across 133 countries, UNCTAD (1998b) found that the number of BITs signed by a host country played only a minor role for both, FDI flows and stocks in 1995.
- The cross-country evaluation of Hallward and Driemeier made use of 20 years of data on bilateral FDI flows from OECD countries to 31 developing countries. Controlling for a time trend, there was little independent role for BITs in accounting for the increase in FDI.

Each approach may have its particular data problems and econometric shortcomings. For example, the reliability of causal inferences drawn from cross-country studies depends on the quality of controlling variables. In a time-series context, foreign investors cannot reasonably be expected to invest where economic fundamentals remain weak after the conclusion of BITs. Yet, it is striking that all available evidence comes to the same conclusion, namely that policymakers are well advised not to put their faith in BITs as a major stimulus to higher FDI inflows. Variables such as market size and growth, exchange rates and country risk turned out to be more important than BITs as FDI determinants in cross-country studies. Time-series studies could only be dismissed if they were dominated by countries lacking locational attractiveness except being signatories of BITs, which is unlikely to be the case.

The proliferation of BITs since the 1990s may have eroded the effectiveness of BITs in attracting FDI. The conclusion of BITs is no longer a distinctive factor signalling host countries’ readiness to offer favorable investment conditions by reducing non-economic risk. Rather, foreign investors tend to regard BITs as a standard feature of the institutional structure prevailing worldwide. In other words,

the proliferation of BITs may be characterized by diminishing returns. Nevertheless, BITs should still turn out to be relevant in empirical analyses, if the few developing countries not taking part were considered relatively risky locations by foreign investors for this reason and, therefore, suffered negative effects on FDI inflows. However, weak economic fundamentals and markets, rather than the absence of BITs, appear to be the major factors working against FDI flows into these countries. BITs per se do little more than enabling multinational enterprises to invest in a partner country. It is a completely different question whether FDI will actually be undertaken as a result of BITs. This is rather unlikely, at least until economic fundamentals are conducive to FDI.

3 Plurilateral Investment Agreements

In the previous section, we argued that there has been a tremendous proliferation of BITs particularly in the 1990s. We also noted that BITs are not a sufficient condition to induce FDI. In essence, the role of the BITs seems to be to ensure some certainty in FDI transactions. From another point of view, it allows countries to pre-commit to certain investment rules which can then be immunized from local interest group interference (Low and Subramaniam 1995). In this section, we will see how the principles underlying bilateral treaties tend to be modified in plurilateral investment treaties (PITs).

Most of the PITs have been of recent origin and immediately preceded or followed the conclusion of the Uruguay Round Agreement in 1995. The signing of PITs also coincided with the tremendous growth in regional trading arrangements (RTAs) (UNCTAD 2001). While not as large in number as the BITs, the PITs (like RTAs) have proliferated mainly in the 1990s with most countries being member of more than one PIT (e.g., UNCTAD 1999a: Chapter IV). Here we will address major issues related to PITs by looking at the treatment of investment in five specific RTAs: the Energy Charter, Free Trade Agreement of the Americas (FTAA), MERCOSUR, NAFTA, and ASEAN. While the first is largely an area-specific RTA involving developed and developing countries, MERCOSUR and ASEAN consist of only developing countries and the remaining two involve both developing and developed countries. Even for RTAs such as FTAA that have not yet come into force, the treaties' intentions and expected features may offer valuable insights. Moreover, a closer look at RTAs may help us understand the factors that led to the failure of the OECD's attempt at an MAI which straddled a large number of developed and developing countries.

There are almost no multilateral agreements which are investment specific. Rather, PITs have largely evolved as chapters or clauses in RTAs. Even the **Energy Charter** focuses on trade, transit and efficiency issues apart from investment. The 52 countries (as of Sept. 2002) which are signatories are drawn from both developing and developed countries of Europe. A number of African countries as well as the United States and Canada have an observer status. In Asia, Japan is a recent signatory. The charter came into force in April 1998, four years after the signing in 1994.

The charter relates only to energy. Being highly focused, the agreement guarantees post-entry non-discriminatory treatment to member country investments. In addition, it guarantees the better of MFN and national treatment in operation (UNCTAD 1996: 555). As concerns pre-entry establishment, however, the charter only allows for a "best endeavour" clause. Furthermore, the charter "grandfathers" existing exceptions and restrictions, and it allows for the reservation of privatized assets for local firms. Finally, the charter includes a comprehensive dispute settlement procedure for both state-state and investor-state disputes. The extremely limited product coverage of the charter has probably allowed for countries to come to an agreement rather quickly. Countries may accede to the charter over time as and when they are ready, thus providing the flexibility required by countries at different stages of development.

The initiative for the **Free Trade Agreement of the Americas (FTAA)** envisages a far more general RTA.⁵ The negotiations were launched in 1998 and the agreement was scheduled to come into force by 2005 (UNCTAD 1998a: 59). In making an inventory of the national rules on investment

already prevalent in prospective member countries, it turned out that there was a high degree of similarity in respect of national and MFN treatment, equality between foreigners and nationals, principles of private property and agreements on dispute settlement. As concerns the last issue, many negotiation partners were already members of the *World Bank's International Convention on the Settlement of Investment Disputes between States and Nationals of Other States* (ICSID; see UNCTAD 1998a: 62–63). The exceptions to MFN were also the same in most of the countries, namely economic integration agreements, tax treaties and bilateral concessionary finance schemes. In international finance, the countries were committed to mobility of capital subject to a balance of payments exception. Finally, there was also convergence in expropriation decrees and compensation criteria. The divergence came in the definition and scope of investment, processes of authorization and registration of foreign investment, treatment of sub-national authorities and industry exceptions. In addition, countries differed on pre-entry and post-entry establishment commitments.

A somewhat different treatment of investment obtains in the **ASEAN** agreement. Concluded in October 1998, the Framework Agreement on the ASEAN Investment Area derives its value from the perceived need to promote the Asian Free Trade Area (AFTA). The agreement includes a waiver of the 30 percent national equity requirement under the ASEAN Industrial Cooperation Scheme, and it extends to all services and modes of supply (UNCTAD 1999a). However, the agreement relies on voluntary cooperation with no legal bindings or dispute settlement mechanisms (UNCTAD 1998a). There is no provision for investor-state dispute resolution in the Protocol on Dispute Settlement Mechanism. Furthermore, the agreement specifies a negative list of industry exceptions and balance of payments safeguards in case of external financial difficulties (ASEAN 1998). The national treatment (including right to entry) is presently limited only to ASEAN investors with a large number of sectoral exceptions to go only by 2010 (UNCTAD 2002). In general, the ASEAN agreement on investment reflects the unwillingness of East and South East Asian countries to being tied down to legal specifics in international agreements (Pant 2002).

The ASEAN RTA has evolved in a series of steps. The 1987 Agreement for the Promotion and Protection of Investments was followed by the Framework Agreement on Economic Cooperation in 1992, the setting up of the ASEAN Investment Area (AIA) at the fifth ASEAN summit and the protocol of 1996 to enhance investor confidence. As a PIT, the ASEAN initiative was much like the MERCOSUR agreement (to be discussed below), i.e. largely meant to promote trade among partner countries. Thus, national treatment was to be extended to non-ASEAN investors only by 2020. The AIA specifically refers only to FDI, which has traditionally contributed a great deal to exports of South East Asian countries in particular. Finally, the agreements do not prevent any of the constituent countries from joining other sub-regional initiatives or growth triangles involving adjacent countries.⁶

By contrast, **NAFTA** provides for a very comprehensive treatment of investment (NAFTA Treaty 1994). The free trade area of Canada, Mexico and the United States comes into full operation by 2005, ten years after NAFTA was agreed upon.⁷ Chapter 11 of the NAFTA Treaty deals specifically with investment. The dominance of the United States in framing the treaty is reflected in the definition of investment, which is extremely broad and includes, apart from both direct investment and portfolio investment, intellectual property and loans. The scope of the agreement extends MFN and national treatment (NT) to both investors and investment. The application of the non-discrimination principles is extended by the addition of the clause on “fair and equitable treatment (FET)” to foreign investors. The treaty specifically states that no formal and substantive rule can be made which would give advantage to local investors. In addition, it is specified that “in like circumstances” there cannot be any discrimination with respect to any sphere of operation of an investment instrument.

The NAFTA Treaty also contains an elaborate dispute settlement mechanism. A regional Dispute Settlement Body (DSB) allows for international arbitration of disputes. No appeal to the host country is available for decisions of the DSB, and the treaty requires that there be some international element involved in any investment dispute. In other words, the DSB is only available where the investor and/or the investment belong to two different country jurisdictions. Unlike most RTAs, there is provision of investor-state dispute settlement (except for pure Canadian companies in Canada) and the private party has the right to nominate one of the three members of the DSB (NAFTA Treaty 1994).⁸

The treaty applies also to sub-national authorities. In a controversial clause, investors are entitled to dispute any governmental action that harms their investment (“regulatory takings”). This has been a bone of contention in the widely publicized Ethyl case in Canada (UNCTAD 1998a).

MERCOSUR is an RTA consisting of Argentina, Brazil, Paraguay and Uruguay with Chile and Bolivia as associate members since 1996. Created under what is known as the Treaty of Asuncion, MERCOSUR was initially to be a common market. Internal struggles and several crises notwithstanding, considerable trade liberalization has been achieved since 1991. This is true especially for internal tariffs. In addition, the common external tariff applied to 85 percent of all products by June 1995 (Machado 1995: 19; Schirm 2002: chapter 4). Somewhat like the EU, MERCOSUR also aimed at a coordinated policy in regional economic fora.

Yet, MERCOSUR has little to offer as a PIT. The only instrument is the 1994 Protocol on Promotion and Protection of Investments from States not Parties to MERCOSUR. Even this instrument only undertakes not to treat foreign investors more favorably than set out in the protocol. Furthermore, the parties signatory to the protocol enjoy the discretion to give or not to give MFN and national treatment to foreign investments. The protocol does not contain any provisions to bar performance requirements or incentives.

In a recent survey, Gestrain (2002) noted that the extent to which signatories to an RTA attempt to establish wide ranging and ambitious rules on foreign investment is largely a function of their previous experience with liberal investment regimes. Thus, for example, provisions very similar to those of NAFTA can be found in the FTAA agenda.⁹ Similarly, the OECD’s attempt at the MAI (discussed in the next section) came after many years of experience with liberal investment regimes in the OECD countries.

Yet, one has to take into account various additional factors to see whether or not RTAs include a comprehensive treatment of investment issues. First of all, it is mainly through BITs, rather than RTAs that negotiations on investment are pursued (Gestrain 2002). Out of the 172 RTAs (as of 2000), only a few deal with investment issues. In contrast to many BITs, investment is narrowly defined as FDI in most RTAs, with NAFTA and possibly also FTAA representing major exceptions. A comprehensive treatment of investment in RTAs may be difficult to achieve if a large and heterogenous (in terms of development criteria like per capita income) set of countries is involved. However, our short account of major RTAs also suggests that RTAs among developing countries have a limited coverage of issues like dispute settlement and national treatment of foreign investors. Developing countries appear to be more oriented towards promoting trade and supporting national companies, rather than foreign investment, when it comes to provisions in RTAs. For example, this applies to both MERCOSUR and ASEAN.

The limitations of many RTAs are particularly striking with regard to dispute settlement. The importance of a dispute settlement mechanism cannot be doubted given the increase in the number of disputes over the last decade. As noted in Gestrain (2002), between 1972 and 1999, 69 disputes were registered with ICSID or about two and a half per year. Between January 2000 and February 2002, 29 disputes were registered, i.e. about 14 per year. Dispute settlement mechanisms are common in BITs, but included in just a few comprehensive RTAs like NAFTA.¹⁰ As we will see in the next section, dispute settlement was also among the contentious issues in the OECD’s attempt at the MAI, which was the first truly multilateral investment initiative. Some of the points raised here come out in stark relief when looking at the factors that led to the failure of the MAI.

4 Multilateral Initiatives on Investment

4.1 The OECD's MAI

It has been argued that the objective to launch talks on the MAI in the OECD reflected the logical culmination of the process of liberalization in the constituent countries as far back as 1961 (Henderson 1999). The aim was to broaden the liberalization process via an investment specific instrument. To put it another way, it was deemed necessary to extend to investment the same liberal treatment that already existed for commodity trade. The MAI essentially attempted to implement the report to the OECD submitted by the Committee on International Investment and Multinational Enterprises (CMIE) and the Committee on Capital Movements and Invisible Transactions (CMIT) in 1995 (OECD 1995). Restrictions on outflows of capital had been almost completely eliminated by 1995. Hence, it seemed logical to extend the liberalization to inflows of capital and to codify these rules in the context of both international movements of investment and services (Henderson 1999). The MAI was supposed to reduce transaction costs, to which the plethora of BITs tended to add. As noted in Section 2, most countries have signed a large number of bilateral treaties, resulting in increasing costs of understanding the regulations governing FDI in any country. Transaction costs can be entry barriers especially for small foreign investors (Gara 2002).

The starting conditions appeared to be favorable at the beginning of MAI negotiations. Exchange controls had gone in all OECD countries along with restrictions on the outward movement of capital. Even though restrictions on inflows of capital remained, inflows of FDI had been deregulated in the context of major liberalizations of domestic financial markets in the 1990s and RTAs like NAFTA, EU and MERCOSUR. A similar liberalization took place in other countries like Australia and New Zealand (Caves and Krause 1984; OECD 1996). The 1980s had witnessed extensive liberalization of inflows of capital in Latin American countries like Brazil and Chile. In the same vein, Asian countries like China, India and those of the ASEAN as well as countries of Eastern Europe had opened up to inflows particularly of FDI (UNCTAD 2000a).

In general, it could be argued that, both for suppliers and demanders of capital, the mood was extremely optimistic in the mid-1990s (Pant 1995). According to Henderson (1999), conditions for an MAI could not have been better than in 1995, in terms of the enabling environment and technical preparedness. Consequently, the MAI represented the most ambitious initiative so far, involving the 29 countries of the OECD and eight developing countries including China, Brazil and Argentina. However, the developing countries had only an observer status and, thus, had little influence on the agenda. In addition, the WTO, World Bank and IMF were represented in MAI negotiations.

As argued in Witherell (1995), the MAI had to be fairly comprehensive to be an improvement over other multilateral instruments and the two existing codes of the OECD which related to the liberalization of capital movements and the liberalization of invisible transactions. Box 2 summarizes the main features of the planned MAI (for details, see Ley 1997; Witherell 1995; UNCTAD 2001).

Despite the favorable environment, however, the MAI discussions broke down in 1998. There were several issues on which substantial disagreement remained. For one, on the 'scope' of the agreement, the United States supported extra territorial application of national laws which was opposed by EU countries (UNCTAD 1999b: 20; Henderson 1999). Second, exceptions for regional integration organizations (the REIO clause that is common in other agreements) were opposed by the United States, in particular on the grounds that such an exception was contrary to the basic objective of market access (UNCTAD 1999b). Third, in the context of 'cultural exceptions', barring the United States, Japan and New Zealand none of the other countries was willing to accept the 'standstill' clause in the audio-visual industry. Fourth, there was considerable disagreement on the introduction of the clause on labor and environmental standards. The MAI was abandoned by the time any agreement on the issue of standards was reached (Henderson 1999). Fifth, the 'pre-entry establishment' clause was supported by the United States, whereas it was opposed by EU countries like France. Finally, there

was disagreement on including the 'investor to state' clause in dispute settlement particularly in the context of 'regulatory takings' (Graham 1998). All this resulted in a plethora of reservations which went into a large number of chapters which are still not available as public documents. Coupled with the exclusion of taxation from the ambit of the MAI, the treaty would at best have been a political liability (Henderson 1999; UNCTAD 1999b).

Box 2

Principal Features of the Planned MAI

- Unlike the previous OECD codes, the MAI was to be a full fledged treaty ratified by legislatures.
- A formal dispute settlement mechanism was planned, including provisions for investor-state and state-state disputes.
- Investment was broadly defined as in the NAFTA agreement.
- All phases of investment, including pre-entry establishment, were to be covered by the principles of non-discrimination (MFN and national treatment).
- Reservations (country-specific exceptions) were subject to 'standstill', 'rollback' and 'ratchet' clauses. In other words, there could be no new reservations and existing ones were time bound.
- The negative list approach was used with regard to general and specific exceptions.
- Performance requirements were to be prohibited or limited, while incentives were to be subjected to well defined rules.
- Right of access to key foreign personnel was to be guaranteed.
- As in GATT, the disciplines of the treaty were to apply to sub-national authorities.

With hindsight, the MAI failed because of a multiplicity of factors (see also Dymond 1999). Some of these were treaty specific. On clauses like cultural exceptions, extra territorial application and dispute settlement there seemed to be no meeting ground even within the set of OECD countries. In addition, many countries were unwilling to commit to the broad definition of investment. It may thus be argued that the initial agenda was over ambitious. Subsequently, a treaty was rendered rather meaningless by the special interests of many countries as well as the number of reservations and exemptions sought (UNCTAD 1999b).

More generally, the political economy of multilateral negotiations changed substantially in the 1990s (Pant 2002; UNCTAD 1999a). The business groups, for example, had considerable interest in the MAI when negotiations started (ICC 1996). Yet, they lost interest with taxation off the agenda, the possibility of minimum labor and environmental standards coming on the agenda, and the dispute settlement mechanism being watered down. At the same time, NGOs emerged as an important force opposing the MAI agenda. The impact of the NGOs (from both developed and developing countries) was aided substantially by the developments in instant electronic communication via the internet (Rothkopf 1998; Mathews 1997). The NGOs projected some aspects of the MAI as impinging on the sovereignty of consumers and individual countries by giving foreign investors rights without obligations. In their view, this was particularly true of investor-state dispute settlement with third party intermediation, regulatory takings, and labor and environmental issues (UNCTAD 1999b).

The broad sweep of the MAI also alienated many countries which saw the prospective treaty as placing private interests above state interests (Henderson 1999; France, le Premier Ministre 1998). It must be remembered that, in the 1990s, the electorate in many countries had returned Left/Centre governments which were more responsive to the concerns of NGOs. In addition, the developing countries were effectively excluded from the negotiations and were offered only the choice to take it or leave it. With developing countries being increasingly opposed to the process, the MAI came to symbolize all that was perceived to be wrong with globalization (Sauve 1998). In the light of all these developments, it would have been political suicide to persist with the MAI.

What are the lessons to be learnt? First of all, the existence of a large number of BITs does not indicate that countries are ready for a comprehensive multilateral treaty on investment. The specific trade-offs that can be negotiated in BITs are not easy to pursue in a multilateral context. Furthermore, an ambitious multilateral negotiation agenda is unlikely to succeed unless it offers scope for quid pro quo-deals between participating countries pursuing different objectives. The potential for such deals was fairly limited in the case of the MAI, as negotiations in the OECD were restricted to investment-related issues. Under such conditions, it might have been more promising if a modest and incremental approach had been taken in MAI negotiations. Considering that even the relatively small and homogeneous group of OECD countries could not agree on the ambitious agenda, it was all the more unlikely that a larger number of heterogeneous countries, including developing countries, were prepared to join.

The situation is different if investment issues are negotiated under the roof of the WTO, where considerable scope exists for quid pro quo-concessions in different areas of negotiations. The Uruguay Round is a reminder to this effect. Therefore, we consider different strategic options open to developing countries in Section 8 below. Yet, the MAI experience suggests an important caveat: If multilateral treaties go beyond trade promotion (the basic objective of GATT) to attempting to homogenize the pace of liberalization in contracting parties, the process of negotiation and the final settlements may be difficult to sell politically. After the conclusion of the Uruguay Round, policymakers in OECD countries pushed ahead with liberalization in areas such as investment without anticipating the resistance emerging among developing countries, NGOs as well as their own electorates. Recently, the wariness about new multilateral initiatives has mounted, especially in developing countries which are dissatisfied with the implementation of the results of the Uruguay Round.

4.2 Multilateral Initiatives in the WTO

The WTO initiatives that impact on foreign investment are largely contained in four agreements: Trade Related Investment Measures (TRIMS), General Agreement on Trade in Services (GATS), Trade Related Intellectual Properties (TRIPS) and Dispute Settlement Undertaking (DSU). While TRIPS and DSU provide minimal standards of protection for investment (Sauve 1998), the main provisions affecting investment are contained in TRIMS and GATS.

The TRIMS measures are reasonably comprehensive in that they ban the imposition of performance requirements on foreign investors. This is not normally a part of BITs, with the notable exception of those BITs involving the United States (Vandeveld 1998; Read 1999)¹¹. In addition, TRIMS includes “standstill” and “rollback” provisions. Countries are required to notify all non-conforming measures to the Council for Trade in Goods, and there is a commitment to roll back these measures in five years for developing countries and seven years for least developed countries. Article III of the agreement imposes national treatment on signatories, while Article XI forbids quantitative restrictions on exports and imports. It has been argued that TRIMS offers a natural base for consideration of a multilateral agreement on investment (Low and Subramaniam 1995; Hoekman and Saggi 2001). However, the principal problem with TRIMS is that it is restricted to trade in goods and does not cover services. Moreover, TRIMS rules have remained highly contentious and various WTO members appear to have violated them.

Important measures for investor protection under the WTO are contained in GATS. To the extent that GATS covers FDI as a mode of supply (“commercial presence”) as well as the movement of related skilled personnel (“temporary movement of natural persons”), its provisions have a direct bearing on investment. Sauve (1998) argued that GATS contains “provisions relating both to matters of investment liberalisation and investment protection, albeit with different degrees of comprehensiveness”. While Article II(1) imposes MFN treatment (a measure of liberalization), transparency (indicating investment protection) across all sectors is required by Article III. However, GATS Article II(v) allows for exceptions to MFN. These exceptions relate mainly to regional trade

arrangements (RTAs), bilateral tax treaties (DTs) and reasons of public health or morality. This is in conformity with most BITs.

Likewise, national treatment is subject to limitations in GATS (Read 1999). National treatment is guaranteed only in service sectors listed in a member country's schedule (Article XVII(1)). The number of sectors where national treatment is granted is expected to increase over time in line with the 'positive list' approach of GATS. In another clause, Article III(3) imposes 'transparency' on members who are required to publish and notify the Council for Trade in Services all laws, regulations and administrative measures relevant to the agreement in the case of committed service sectors (Read 1999).

According to Article XXIII, all disputes relating to GATS are to be governed by the Dispute Settlement Undertaking (DSU). The DSU contains the usual provisions for negotiations, consultations, arbitration and compensation (Sciarra 1998). However, unlike the NAFTA agreement, there is no provision for investor-state dispute settlement.

Even though TRIMS and GATS offer a number of provisions relating to investment, the main lacunae are in the context of expropriation, compensation and subrogation (Read 1999). In addition, provisions for investor-state dispute settlement are missing. A multilateral agreement on investment might help fill these gaps. However, following this route involves several critical issues. First, in the case of commodity trade, it is easy to associate traded goods with particular countries. This is not always possible in the context of FDI, as the principal feature of transnational corporations is that their base of operations spans several countries. Second, multilateral attempts to constrain a country's sovereignty through redefinition of jurisdiction (as investor-state dispute settlement would do) would be as hotly contested by developed as developing countries. The concern is that this would confer advantages to foreign companies not available to local companies, which could be considered "reverse discrimination". As we have seen earlier, this issue contributed to the breakdown of OECD talks on the MAI. Subsequently, we will discuss whether there are better prospects for a multilateral framework for investment in the context of WTO negotiations.

5 Why a Multilateral Framework?

5.1 Conflicting Interests

The earlier failure of OECD countries to conclude the MAI notwithstanding, industrialized countries, including the EU, are pressing for a multilateral agreement on investment to be integrated into the WTO framework. The negotiating stance of industrialized countries largely reflects the business perspective in these countries. For instance, according to UNCTAD (1999a: 140), the Union of Industrial and Employers Confederations in Europe (UNICE) "attached high priority to the establishment of a global regime for FDI that is non-discriminatory, transparent, stable and liberal". UNICE claimed that appropriate provisions on FDI would be in the interest of WTO members at all levels of development. Likewise, the International Chamber of Commerce (ICC) argues that a single set of legally binding multilateral rules and disciplines to govern international investment is needed for two reasons: firstly to better protect the great volume of existing FDI and to facilitate further expansion; secondly to replace the large and rapidly growing number of overlapping legal instruments and initiatives in the investment area (DSE Forum 2002: 40 f.).

A multilateral framework replacing the intricate net of bilateral and plurilateral rules would improve transparency and reduce FDI-related transaction costs. This could indeed be in the mutual interest of foreign investors and host countries. By rendering FDI more profitable, lower transaction costs may

induce higher FDI flows from which host countries may derive benefits. In addition, foreign investors and host countries alike may gain from a less distorted allocation of FDI.¹² While conclusive evidence on FDI diversion resulting from BITs is lacking (see Section 2), the complexity of the currently prevailing regulatory environment makes discriminatory practices more likely. Discrimination, which frequently invites bureaucratic interference and corruption, may hinder investors to enter superior locations and host countries to attract superior investments.

Nevertheless, various developing countries remain skeptical whether they would benefit from a multilateral investment agreement. The fear is that the bargaining position of developing host countries would weaken further. As pointed out by Kokko (2002), the TRIMS agreement has already tilted the playing ground in favor of multinational enterprises (MNEs). While this agreement prohibits measures (e.g., performance requirements) traditionally applied to promote so-called development friendly FDI, it does not limit the scope for subsidy-based competition for FDI. A multilateral investment agreement aiming primarily at protecting existing FDI and encouraging additional FDI may shift the balance of power even more in favor of MNEs.

Policymakers from developing countries emphasize the need to take due account of national development goals and policies in a multilateral investment agreement.¹³ This position is supported by many NGOs. UNCTAD (1999a: 140) summarizes their view as follows:

“The main priority for international negotiations is not liberalization, but setting a framework to ensure that international investment promotes sustainable development and real economic efficiency. Specific priority areas for rules include investor behavior and transparency, competition and restrictive business practices, regulation of investment incentives, and support for least developed countries to enable them to attract high quality investment.”

As it seems, conflicting interests are mainly between industrialized and developing countries. It fits into this picture that, for instance, the Minister of Small and Medium Enterprises and Commerce of Senegal argued for a “compromise between the investor and the receiving country in question” (DSE Forum 2002: 39). However, recent research on where the economic benefits of FDI go suggests that interests tend to diverge also among developing countries. This is not only because some developing countries, notably those offering neither promising markets nor relevant cost advantages, may not have reasonable chances to attract FDI, no matter what investment agreement they sign. In addition, the bottom line of various empirical investigations appears to be that developing countries must have reached a minimum level of economic development before they can capture positive effects of inward FDI on economic growth.¹⁴ Higher-income developing countries have better prospects than low-income countries to benefit from economic spillovers of FDI by absorbing superior technology and knowledge. Hence, more advanced developing countries may find it easier to accept, as a *quid pro quo*, the demands of MNEs and industrialized countries for clearly defined multilateral rules. By contrast, the cost-benefit calculus of poorer countries for which FDI has less to offer may lead them to reject such demands.

The finding that beneficial effects of FDI in developing host countries cannot be taken for granted has further implications, which will be discussed in the remainder of Section 5. It is far from obvious that FDI would have more favorable effects in poor countries, if a “development clause” were to be included into a multilateral investment agreement. Similarly, it is open to question whether a “balanced” agreement, containing corporate obligations in addition to rules binding host countries, would foster transfers of technology and know-how. Strict obligations may rather discourage MNEs from investing in poor developing countries altogether.

However, as argued in the following, wishful thinking also prevails on the part of those pushing for the liberalization of FDI regulations through a multilateral agreement. Cost savings are likely to be limited as a multilateral agreement would not replace, but rather complement bilateral and plurilateral agreements. Moreover, the importance of transaction costs, relative to other determinants of FDI in developing countries, tends to be overstated. As a consequence, it is unlikely that a multilateral agreement would induce significantly more FDI in developing countries.

5.2 The Relevance of Transaction Costs

A multilateral investment agreement could potentially reduce transaction costs related to FDI by providing for a transparent regime of rules and regulations. As argued in OECD (2002: 176 ff.), a lack of transparency may deter FDI in several ways:

- It adds to operational risks for MNEs and imposes higher information costs on them.
- It gives rise to information asymmetries which tend to benefit market incumbents and discourage FDI by new entrants.
- It may lead to adverse selection among foreign investors, by favoring those who possess privileged information and are politically well connected in the host country.

An illustrative list of transaction costs caused by a lack of transparency in rules and regulations governing FDI has been presented by UNCTAD (1999a: 179 f.); this list, which largely applies to domestic investment as well, is shown in Table 1. The cost effects of lacking transparency in these respects are impossible to quantify. Yet, UNCTAD reckons that unclear rules and regulations “can increase the transaction costs of investment and operations significantly” (*ibid.*). In a similar vein, OECD (2002: 176) stresses that “a lack of transparency will almost certainly discourage foreign investors”, even though transparency *per se* will not induce FDI if other deterrents remain. To support this argument, OECD refers to a recent study by the Asian Development Bank Institute on various aspects of transparency in 55 (industrialized and developing) countries. It turns out that inward FDI is relatively low where transparency is poor.

Nevertheless, the relevance of a multilateral agreement on investment for enhancing transparency and reducing transaction costs is questionable on several grounds. For a start, even if all transaction costs listed in Table 1 were addressed by such an agreement, other FDI-related transaction costs would remain unaffected. Hoekman and Saggi (2000: 643) argue in this context that “the major proportion of the transaction costs associated with FDI is likely to arise from differences in language, culture, politics, and the general business climate of a host country [rather than from the costs imposed by the multitude of BITs on multinational firms]”.

Even for cost elements to be addressed in a multilateral agreement, reductions in transaction costs will be less than hoped for by the business community. A far-reaching multilateral agreement might render various less comprehensive BITs redundant. However, the Doha Round will at best mark the starting point of a long-term process towards substantive and binding multilateral investment rules. Most, if not all, bilateral and plurilateral investment agreements will remain in place for the time being. Investment agreements of different sorts with narrow or broad membership will coexist, as is the case in international trade.¹⁵ A multilateral agreement would define the smallest common denominator of WTO members, while regional groupings or bilateral partners would still be free to go beyond commonly agreed rules. In other words, the realistic scenario with regard to investment rules is what trade negotiators labelled a “GATT plus”-framework.

The expected pattern of a “GATT plus” (or, rather, “WTO plus”)-type framework for international investment is easy to explain in collective action terms. The degree of common interests and perspectives is typically higher among a smaller homogenous group of countries; coordination problems mount with the number of contracting parties. It follows that more and stricter investment rules can be fixed in BITs and regional agreements. As Sauvart (2000: 9) put it, “what would be acceptable at the bilateral or even at the regional level may not necessarily be acceptable at the multilateral level.” The unpleasant consequence for foreign investors is that they will continue to encounter considerable information needs and transaction costs resulting from a lack of transparency, when planning to invest in a country which is WTO member and, at the same time, contracting party of more far-reaching investment agreements. The remaining complexity of trade regulations at different levels is a clear reminder to this effect.

Table 1: Transaction Costs Related to the Legal and Regulatory Environment for FDI

	Transaction	Enterprise exposure	Effects on:
Business entry	Registration	Monetary costs fo firm	Rate of new business entry
	Licensing	Time costs (including	Distribution of firms by size,
	Property rights	compliance and delays)	age, activity
	Rules	Facilitation costs	Size of shadow economy
	Clarity	Expert evaluations of rules	Rate of domestic investment
	Predictability	and their functioning	FDI inflows, quantity and
	Enforcement	Number of rules and	quality
	Conflict resolution	formalities	Investment in R&D
Business operation	Taxation	Cost of compliance	Business productivity
	Trade-related regulation	Higher costs of operation	Export growth
	Labor hiring/firing	Costs of conflicts and conflict	Size of shadow economy
	Contracting	resolution	Growth of industries with
	Logistics	Search costs and delays	specific assets or long-
	Rules	Insufficient managerial	term contracting
	Clarity	control	Rate of innovation and R&D
	Predictability	"Nuisance" value	Rate of business expansion
	Enforcement	Problems in making contracts	Rate of investment in new
	Conflict resolution	Problems in delivery	equipment
Business exit			Subcontracting
	Bankruptcy	Rate of change of rules	Rate of exit (and entry)
	Liquidation	Changes in costs and number	Prevalence of credit
	Severance/layoffs	of rules	Distribution of profitability
	Rules	Availability of rules and	of corporations
	Clarity	documents to firms	
	Predictability	Rates of compliance and/or	
	Enforcement	evasion	
	Conflict resolution	Use of alternatives to formal	
		institutions	

Source: UNCTAD (1999a: 179 f.) on the basis of World Bank information.

It may actually be the foreign investors themselves who will contribute to the emergence of a “WTO plus”-framework. This could happen if, as widely assumed, multilateral negotiations on investment strengthened the bargaining position of developing countries. As a consequence, the business community may lose interest in a multilateral agreement, and instead prefer the stronger protection of investors' rights in BITs (World Bank 2003: 127).

5.3 Transaction Costs and Inward FDI

There is another reason for not expecting too much from a multilateral investment agreement in terms of transaction cost reductions. Survey results on investment conditions in 28 developing countries, presented by the European Round Table of Industrialists (ERT 2000) in cooperation with the United Nations and the International Chamber of Commerce, suggest that impediments to FDI that give rise to transaction costs have already been relaxed substantially, largely on a unilateral basis, throughout the 1990s.¹⁶ It is, thus, debatable whether a multilateral agreement is needed as urgently as suggested by statements on the significance of transaction costs made by the business community.¹⁷

ERT (2000) lists country-wise impediments to FDI on a scale ranging from 0 (most liberal) to 6 (most restrictive). In this section, we consider impediments that give rise to transaction costs (see Box 3 for details). These impediments are grouped into five indices: administrative bottlenecks, entry restrictions, post-entry restrictions, risk factors and technology-related regulations. Table 2 indicates that transaction costs have come down considerably in all five dimensions, if ERT's assessment of the severity of FDI impediments provides a reasonable yardstick:

- In the early 1990s already, the average score of all sample countries was below 2 (i.e., fairly liberal) in all dimensions except for entry restrictions.
- As concerns changes between 1992 and 1999, just eight out of 140 country-specific entries in Table 2 point to higher transaction costs at the end of the observation period.
- For only two countries (Guatemala and Sri Lanka), FDI impediments were rated more restrictive in 1999 in more than one dimension.
- The average score of all sample countries declined to about half the score in 1992 for each of the five indices.

All this suggests that foreign investors do not have not to wait for a multilateral agreement on investment in order to benefit from transaction cost reductions. This applies especially to some specific factors that figured prominently among investors' concerns in the more distant past. Relevant examples are the risk of nationalization or expropriation (subsumed under risk factors in Table 2) and exit restrictions, including restrictions on the repatriation of capital (subsumed under post-entry restrictions in Table 2). According to the survey results of ERT, the threat of nationalizations or expropriations has diminished tremendously. The number of sample countries where it was considered relevant at all declined from 13 in 1992 to 5 in 1999 (among them India and China, though their score of 0.5 indicated a fairly low risk of expropriation). A similar move towards liberalization is reported for exit restrictions; in this regard, India's score improved from 2 in 1992 to 1 in 1999 (China: 2 in 1992 versus 0.5 in 1999). A multilateral agreement may help lock in previous liberalization measures undertaken unilaterally, and render such measures more difficult to reverse. However, there appears to be little a multilateral agreement can offer in terms of further reducing the risk of expropriation and liberalizing exit restrictions.

Correlation and regression analyses that we performed on the link between the indicator values presented in Table 2 and inward FDI in the sample countries support the view that transaction cost-related impediments to FDI were of minor importance in the past already.¹⁸ For a start, we calculated bivariate (Spearman rank) correlation coefficients between the indices in Table 2 on the one hand, and FDI stocks in 1999 and FDI inflows in 1997–2000 on the other hand.¹⁹

Box 3

Survey Results by the European Round Table of Industrialists on Impediments to FDI Giving Rise to Transaction Costs

Comparable survey results are available from ERT (2000) for 28 developing countries and the years 1992, 1996 and 1999. We draw on ERT findings for the first and the final year. The checklist of ERT covers 33 items, ranging from restrictions on overall management control and freedom of decision of private investors to criminality and civil disturbances in the sample countries. We focus on those impediments that give rise to transaction costs.

We consider the following ERT items and aggregate them into five indices, by averaging survey results on specific items:

1. *administrative bottlenecks*
 - inefficient administration and red tape
2. *entry restrictions*
 - ownership restrictions: mandatory state or local partnership; limitations related to industrial property and land;
 - access to sectors and activities: industries reserved for the state or local enterprises; restrictions related to acquisition of existing enterprises; minimum investment requirements;
 - approval procedures: discrimination against private business or FDI; complex procedures; rapidly expiring licenses; red tape.
3. *post-entry restrictions*
 - management control/freedom of decision: political pressure on management; discretionary state intervention;
 - performance requirements: requirements with regard to exports, local content and manufacturing; foreign exchange neutrality; import and local sales licenses depending on export performance;
 - foreign exchange transactions: restrictions with regard to profit remittances, import financing and payment of fees; delays imposed on transfers; additional taxation of remittances;
 - exit restrictions: restrictions on repatriation of capital;
 - price controls: freezing prices and/or wages;
 - marketing and distribution: interference in the structure of sales organizations and product distribution.
4. *risk factors*
 - inconsistent, unclear and/or erratic regulations;
 - risk of nationalization or expropriation;
 - shortcomings in legal and regulatory systems;
 - political instability;
 - environmental risks (e.g., contingent liabilities for previous environmental damage);
 - high rates of criminality;
 - civil disturbances and violence.
5. *technology-related regulations*
 - intellectual property protection: insufficient protection for patents, copyrights, trademarks etc.; no, insufficient or highly taxed remuneration for brand use, technical assistance and technology transferred;
 - technology targeting: interventions into corporate technology transfers; pressure to dissipate a company's R&D efforts; insistence on local R&D.

Some of the specific items will be considered separately in Section 6 on performance requirements. It should also be noted that the assessment of FDI impediments, especially the weighting done by ERT, may be rather subjective. This drawback which is common to surveys, has to be accepted in the absence of hard (quantitative) data. Moreover, it is foreign investors who take locational decisions so that ERT is probably best qualified to assess the restrictiveness of FDI impediments in potential host countries.

Source: ERT (2000); Nunnenkamp and Spatz (2002).

Table 2: Transaction Cost-Related Impediments to FDI in 28 Developing Countries^a 1992 and 1999

	Administrative bottlenecks		Entry restrictions		Post-entry restrictions		Risk factors		Technology-related regulations	
	1992	1999	1992	1999	1992	1999	1992	1999	1992	1999
Argentina	0.5	0.5	0.7	0	0.6	0.3	0.1	0	1.0	0.5
Bangladesh	2.0	1.5	1.0	0.7	0.7	0.3	0.6	0.4	2.0	1.0
Brazil	1.0	0	1.3	0.7	1.2	0.3	0.7	0.2	2.5	0.5
China	3.0	2.0	3.7	2.7	3.3	2.4	1.6	0.9	2.5	1.3
Colombia	2.0	0	2.5	1.0	0.8	0.8	0.7	0.3	2.0	2.0
Ecuador	1.0	1.5	2.0	0.8	0.7	0.4	0.4	0.1	1.0	0.8
Egypt	2.0	2.0	3.0	1.8	1.1	0.5	0.6	0.1	2.0	1.3
Ghana	2.0	0	3.0	1.0	0.5	0.2	0.4	0.1	1.0	0.3
Guatemala	0	0	0.8	1.0	0.7	0.3	0.1	0.6	1.5	0.8
India	3.0	1.0	2.3	1.3	1.5	0.9	1.4	0.4	2.5	2.3
Indonesia	2.0	0	3.3	1.2	1.5	0.3	1.1	0.4	2.0	0.8
Iran	3.0	1.0	3.8	2.7	2.4	1.8	1.3	0.3	2.5	2.0
Kenya	2.0	1.0	2.3	1.3	1.7	0.2	0.7	0.7	1.5	0.8
Korea, Rep.	1.0	0	3.3	1.2	1.3	0.5	0.6	0.3	2.5	1.3
Malaysia	0	0	2.8	2.0	1.8	1.0	0.4	0	2.5	3.0
Mexico	1.0	1.0	3.0	0.5	1.3	0.2	0.4	0.3	1.0	0.5
Nigeria	3.0	2.5	3.3	1.0	2.2	0.5	1.9	0.8	2.5	1.5
Pakistan	2.0	1.0	1.3	0	1.3	1.3	0.8	0.6	1.5	1.3
Philippines	1.0	2.0	2.2	1.2	1.7	0.8	1.1	0.3	2.5	1.0
Saudi Arabia	0	0	3.2	3.3	0.8	0.7	0.4	0.1	1.8	1.0
Sri Lanka	1.0	1.0	1.7	1.3	1.0	0.3	0	0.6	0	1.0
Syrian Arab. Rep.	3.0	2.0	3.0	1.7	2.8	1.5	1.7	0.9	1.5	0.3
Taiwan	0	0	2.0	1.3	1.3	0.8	0.4	0.1	2.5	1.8
Thailand	0	0	4.0	1.5	1.0	0.6	2.3	0.3	1.5	0.3
Tunisia	1.0	0	0.5	0.5	0.8	0.8	0.6	0.1	2.5	1.0
Turkey	3.0	2.0	2.3	0.8	0.8	0.5	0.4	0.3	2.5	1.5
Vietnam	3.0	1.0	3.8	1.8	2.3	0.9	1.6	0.4	3.0	2.5
Zimbabwe	3.0	2.0	3.0	1.5	1.8	0.3	1.7	1.1	1.5	0.3
Average 28 DCs	1.6	0.9	2.5	1.3	1.4	0.7	0.9	0.4	1.9	1.1

^aSurvey results ranging from 0 (most liberal) to 6 (most restrictive); see Box 3 for a more detailed description of survey items and aggregation into indices.

Source: ERT (2000).

The first two columns of Table 3 suggest that more serious administrative bottlenecks and higher risks discouraged inward FDI in a significant way. However, inward FDI was not correlated significantly with either entry restrictions, post-entry restrictions, or technology-related regulations.²⁰ This provides a first indication that the distribution of FDI among developing countries was shaped by locational factors other than transaction costs captured by these three FDI impediments. For instance, per-capita FDI stocks in 1999 were highest in Malaysia among all sample countries, even though this country was rated relatively restrictive with regard to entry conditions and technology-related regulations.

Table 3: Transaction Cost-Related FDI Impediments and Inward FDI: Correlation and Regression Results

FDI impediments ^a	bivariate correlations ^b		partial correlation coefficients ^c	
	FDI stocks in 1999	FDI flows in 1997–2000	FDI stocks in 1999	FDI flows in 1997–2000
administrative bottlenecks	–0.53***	–0.39**	–0.23	–0.17
entry restrictions	–0.09	–0.01	–0.10	–0.17
post-entry restrictions	–0.01	0.04	–0.11	–0.18
risk factors	–0.62***	–0.54***	–0.24	–0.03
technology-related regulations	–0.01	0.02	0.07	–0.12

*, **, *** significant at 10 percent, 5 percent and 1 percent level, respectively (two-tailed).

^aAs of 1999 for correlations with FDI stocks; as of 1996 for correlations with FDI flows. – ^bSpearman rank correlation coefficients; inward FDI in US-Dollar per capita of the sample countries' population. – ^cSee text for underlying regression and calculation procedure; inward FDI in million US-Dollar.

Source: Nunnenkamp and Spatz (2002).

The minor importance of transaction costs, as reflected in the indices on FDI impediments, is borne out more clearly once we control for market-related determinants of FDI in developing countries. In a simple multivariate regression analysis, we examined whether transaction cost-related impediments provide explanatory power for the distribution of FDI over and above the host countries' population and GDP per capita. We ran a regression of log FDI (flows and stocks, respectively, in million US-Dollar) on log population, log GDP per capita and each of the five indices on FDI impediments.²¹ The two market-related determinants of FDI turned out to be highly significant in all regressions.²² The t-values of these regressions were then used to calculate the partial correlation coefficients of each index on transaction cost-related FDI impediments with both, FDI stocks and FDI flows. All partial correlation coefficients are insignificant (see the third and fourth column of Table 3). This implies that even the role of administrative bottlenecks and risk factors in explaining the distribution of FDI among developing countries is small at best, if market-related variables are controlled for.

Our findings underscore the view of Hoekman and Saggi (2000: 642 f.) and Singh (2001), who consider transaction costs to be a weak argument for a multilateral agreement on investment. Furthermore, as argued before, it is far from clear that transaction costs would be substantially lower than under current conditions in the counterfactual situation of a multilateral investment agreement. Of course, it cannot be ruled out that FDI in developing countries would have been still higher if multilateral rules had existed. Yet it should be noted that the boom of FDI in developing countries occurred without a multilateral investment agreement (Singh 2001), and some countries, notably China and Malaysia, attracted enormous amounts of FDI despite their relatively restrictive investment regimes.

5.4 Developing Countries' Demands for Flexible Rules and Corporate Obligations

According to Singh (2001), the attractiveness to FDI of countries such as China and Malaysia also proves the case for flexible investment rules, which would allow for selectivity of developing host countries in targeting and regulating inward FDI. A strict application of WTO principles such as national treatment and MFN to FDI is deemed harmful by this author to economic development in the Third World. It is for several reasons that developing countries are urged to monitor and regulate the

amount, structure and timing of FDI: (i) to avoid financial fragility, (ii) to prevent crowding-out of domestic investment, and (iii) to promote economic development by technology transfers and economic spillovers.

Likewise, the request for a balanced multilateral agreement to include corporate obligations is meant to improve the developmental impact of FDI in the Third World. Corporate obligations are considered a vital element of a multilateral agreement, as MNEs “often only aimed at maximizing their own profits” (DSE Forum 2002: 39). The profit motive of MNEs may conflict with development needs of the host countries of FDI and, thus, provides a rationale for restrictive FDI policies if market failure is prevalent: “Since multinational firms typically arise in oligopolistic industries, the presence of imperfect competition in the host country is an obvious candidate” (Hoekman and Saggi 2000: 632).

It is mainly with regard to corporate obligations that developing countries may achieve a better deal by negotiating multilaterally on investment. As noted in Section 2, BITs typically do not include provisions against restrictive business practices. Bargaining asymmetries will be easier to overcome if the request for corporate obligations is coordinated among developing countries. The wish-list of multilateral rules on corporate behavior includes the following (for details, see CUTS 2001; 2002):

- observance of human rights, labor rights and environmental protection ("Global Compact");
- corporate disclosure and accountability;
- respect for national laws;
- social responsibility, e.g., with regard to illicit payments and product safety;
- transparency in transfer pricing;
- precautions against restrictive, abusive and unfair business practices (e.g., market segmentation, discriminatory pricing, collusion, exclusive dealing);
- promotion of technological dissemination, local entrepreneurship and local workers.

Even though it was for good reasons that developing countries have resisted linking trade with labor and environmental standards and human rights, they would now like to have binding rules on corporate behavior in these respects. Previously established guidelines and codes of conduct are dismissed as insufficient. Similar to restricting incentives-based competition for FDI (see Section 7 below), however, the real challenge is enforceability. The critique leveled against non-binding guidelines, that they have little impact on corporate behavior, may apply to binding rules, too, unless they can be enforced effectively.

In essence, developing countries demand more flexible rules with regard to their own behavior and more binding rules with regard to corporate behavior in order to improve the developmental impact of FDI. Developing countries may be tempted to dismiss the opposition of industrialized countries and MNEs against these demands by pointing to the selfishness of opponents in the political bargaining process. Yet, developing countries should take into account that their demands also give rise to some economic questions. In the subsequent paragraphs, we address possible trade-offs and opportunity costs, and discuss the effectiveness of “development clauses” in a multilateral investment agreement.

Possible trade-offs are twofold. First, the required flexibility of rules on FDI policies by host countries comes at the cost of transparency and predictability. According to Sauvant (2000: 10), a balance has to be achieved: “On the one hand, it is unavoidable that any international agreement – almost by definition – establishes certain obligations that reduce the freedom of action for any signatory and that, on the other hand, the distinct and specific needs of any particular country to promote its own development objectives in light of its own situation need to be taken into account.” In striking this balance, negotiators should be aware that the transaction-cost argument, discussed in the previous section, might become irrelevant altogether if rules were to become rather flexible. Put differently, reductions in transaction costs will be the less, the more flexible rules become.

Second, while corporate obligations can only have an impact on the quality of inward FDI if they are binding and enforceable,²³ strict obligations may reduce the quantity of inward FDI. Foreign investors are always free not to invest if profit opportunities are considered poor in the light of obligations to be fulfilled. This might not be a problem for recipient countries if only “development-unfriendly” FDI projects were discouraged in this way. It cannot be ruled out, however, that foreign

investors would generally become more reluctant. Almost by definition, the profits of MNEs and, thus, their incentive to undertake FDI will decline to the extent that developing countries succeed in shifting rents from MNEs to host countries by imposing binding obligations on the former.

Likewise, the effectiveness of flexible rules and “development clauses” cannot be taken for granted. The special treatment developing countries were granted in trade is a clear reminder in this regard.²⁴ Trade preferences traditionally rule the way many developing countries perceive the GATT/WTO, even though they “did little for the poor countries” (Bhagwati 2002: 27).²⁵ The economic results from special treatment in trade have been “disenchanted” (Langhammer 1999: 21) according to several studies. Well-intended as they were, trade preferences did the poorest WTO members no good in promoting their world-market integration. Rather, the special treatment appears to have discouraged African countries, for example, from actively participating in trade negotiations by committing themselves to binding trade liberalization (*ibid.*). As a result, African markets are still most heavily protected. Another consequence was that developing countries insisting on preferential treatment were no relevant negotiation partners for industrialized countries in various trade rounds: “The rich countries, denied reciprocal concessions from the poor countries, wound up concentrating on liberalising trade in products of interest largely to themselves” (Bhagwati 2002: 26). The implication for multilateral negotiations on investment is fairly obvious: It is rather unlikely that developing countries can achieve much, e.g. with regard to binding corporate obligations, if they are not prepared to constrain flexibility on their own part.

Besides *quid pro quo*-considerations in the political bargaining process, it should be taken into account that market failure provides a necessary, but not a sufficient condition for flexible rules to be effective in promoting development-friendly FDI in developing countries. Hoekman and Saggi (2000: 636), though acknowledging the relevance of market failure, emphasize that “in practice it is rather difficult to design strategic [FDI] policies that are effective. The informational requirements for formulating a successful policy are substantial and such policies invite lobbying and other socially-wasteful activities. ... The best rule of thumb for policy-makers is to refrain from pursuing strategic policies.”

The general skepticism of these authors on whether flexibility and selectivity will help promote development-friendly FDI may be specified in several respects.²⁶ For instance, developing countries in Asia (e.g., Korea and Taiwan) chose to restrict FDI and instead to rely on domestic investors in technologically advanced industries, in order to strengthen local technological capabilities. According to UNCTAD (1999a: 173), selective FDI policies paid off in some of these countries; “in many cases, however, the emergence of successful domestic producers in a new, technologically-advanced industry is unlikely or might take a long time with uncertain results. An example of a costly intervention in favour of domestic firms in high-technology industries is the Brazilian informatics policy of the early 1980s, which involved restrictions on FDI.”

In other words, it cannot be simply assumed, as in Singh (2001), that some success stories of flexible and selective FDI policies could be easily copied by all developing countries. Poor developing countries in particular, may lack administrative capabilities to effectively screen FDI and channel foreign investors into activities which foster national economic development. Government failure may then hamper economic development even more seriously than market failure.

Finally, in the course of time, selective FDI policies may turn out to be less successful than first-round effects suggest. The empirical results of Agosin and Mayer (2000) on FDI-induced crowding-out and crowding-in of domestic investment provide an example. According to Singh (2001), the findings of these authors strengthen the case for selective FDI policies, as crowding-in was observed in Asian countries with less liberal FDI policies, whereas crowding-out prevailed in more liberal Latin America. This misses a point made in a recent OECD study: “Crowding out of domestic investment through FDI may not necessarily be a problem, and can even be a healthy sign” (OECD 2002: 64). The host economy may benefit if local enterprises lacking competitiveness are replaced by foreign firms, provided that released domestic resources are used for more productive purposes. With hindsight, it might have been not so bad after all if Asian governments had allowed MNEs to outcompete local firms; this might have helped prevent over-investment in unproductive activities.

6 Performance Requirements: Making a Fuss about a Minor Problem?

Conflicts of interest between developing and developed countries appear to be particularly pronounced with regard to performance requirements. Developed countries are widely expected to intensify pressure on developing countries to abolish performance requirements when it comes to multilateral negotiations on investment. Taking further into account that many BITs do not prohibit performance requirements, it is less likely than noted before in the context of corporate obligations that developing countries will achieve a better deal on performance requirements in multilateral negotiations. In other words, multilateral negotiations may improve the bargaining position of developing countries in some respects, but not necessarily in all respects. As a matter of fact, the resistance of developing countries to enter into multilateral negotiations under the WTO umbrella seems to be largely because they regard performance requirements as an essential means to improve the “quality” of FDI inflows.

The opposing objectives of developing and industrialized countries and the ensuing controversy suggest that performance requirements are widely used and considered a major bottleneck to FDI by multinational enterprises. All the more surprisingly, OECD (2002: 185) notes: “Little concrete evidence is available to shed light on the pervasiveness of performance requirements.” Under the TRIMS agreement which prohibits certain types of performance requirements (e.g. export restrictions, trade-balancing requirements and local content obligations), only 26 countries had notified performance requirements that did not conform with this agreement, and many of these requirements have since been repealed (OECD 2002). On the other hand, notifications may seriously underreport the actual use of TRIMS, which is now one of the implementation issues in the Doha agenda.²⁷

Survey data on investment conditions in 28 developing countries, presented in ERT (2000), indicate that both the proponents and the critics of performance requirements miss an important point: The implicit assumption made on both sides of the debate, namely that performance requirements are highly relevant, seems to be in conflict with the available evidence.

The ERT-survey covers various aspects of investment conditions in the 28 sample countries. The following three items, included in the checklist, are of particular interest in the present context:²⁸

- performance requirements related to exports, local content, manufacturing and foreign exchange neutrality (including requirements that are not codified);
- requirements related to employment conditions (discrimination of foreign investors against comparable local employers) and work-permits for international staff;
- technology targeting, i.e., interventions into the corporate transfer of technology and insistence on R&D efforts in the host country and R&D dissipation.

For each of these items, ERT (2000) lists country-wise impediments to FDI on a scale ranging from 0 (most liberal) to 6 (most restrictive). As mentioned in Section 5.3, the scoring may be criticized for the subjectivity involved and the limited number of host countries under consideration. Moreover, restrictive performance requirements tend to be concentrated in some industries such as automobile production. Nevertheless, Table 4, which presents the results for 1992 and 1999, i.e., the first and the final year for which comparable surveys are available, reveals some interesting insights. Even in the early 1990s, the restrictiveness of performance requirements was considered rather low for the average of all sample countries; the average score was below 2 in 1992 already. Moreover, the average score declined significantly during the 1990s, indicating a relaxation of performance requirements in all three dimensions. Performance requirements became less restrictive in almost all sample countries.²⁹ Specific exceptions are: employment requirements in Nigeria and Zimbabwe, and technology targeting in China.

Table 4: FDI Impediments Related to Performance Requirements in 28 Developing Countries^a 1992 and 1999

	Export, local content and manufacturing requirements		Employment requirements		Technology targeting	
	1992	1999	1992	1999	1992	1999
Argentina	1	0.5	0.5	0.5	0	0
Bangladesh	1	0	3	3	1	0.5
Brazil	0.5	0	1	1	2	0
China	4	3.5	2.5	2	0	0.5
Colombia	1	1	1	0.5	1	1
Ecuador	1	1	0	0	0	0
Egypt, Arab Rep.	2	1	3	2	0	0
Ghana	1	0	2	1.5	1	0
Guatemala	1	0	2	1	0	0
India	1.5	1	3	2	0	0
Indonesia	3	0	2	1	0	0
Iran, Islamic Rep.	3	3	3	1	0	0
Kenya	2	0	0	0	0	0
Korea, Rep.	0	0	1	0	2	0
Malaysia	3	2.5	2	2	2	2
Mexico	2	0	2	1	0	0
Nigeria	3	0.5	2	2.5	0	0
Pakistan	3	3	2	0	0	0
Philippines	2	1	2	0	2	0
Saudi Arabia	0	0	2	1	0	0
Sri Lanka	2	1	0	0	0	0
Syrian Arab Rep.	2	2	3	2	3	0
Taiwan	1	1	1	0	1	1
Thailand	2	1	2	0	0	0
Tunisia	0	0	3	1.5	3	0
Turkey	0	0	1	0	0	0
Viet Nam	0	0	2	1.5	1	1
Zimbabwe	3	0	0	1	0	0
Average 28 DCs	1.6	0.8	1.7	1.0	0.7	0.2
Coefficient of variation ^b	0.7	1.2	0.6	0.9	1.4	2.2

^aSurvey results ranging from 0 (most liberal) to 6 (most restrictive); see text for a more detailed description of survey items.
^bStandard deviation divided by mean.

Source: ERT (2000).

More surprisingly perhaps, a (Spearman rank) correlation analysis does not support the proposition that more restrictive performance requirements tend to discourage FDI in a significant way. For lack of sectorally disaggregated data on performance requirements and FDI in the sample countries, we correlate performance requirements as given in Table 4 with overall (inward) FDI stocks per capita of the host countries' population.³⁰ The correlation coefficients shown in Table 5 are statistically insignificant, which is in conflict with the proposition underlying the negotiating stance of developed countries in the WTO. For technology targeting, the coefficients even reveal a positive correlation with FDI stocks.³¹ Although the evidence is admittedly weak, the most heavily disputed performance requirements related to exports, local content, manufacturing production and foreign exchange neutrality may have become less relevant as a hindrance to FDI during the 1990s.

Table 5: Performance Requirements^a and Inward FDI Stocks^b: Spearman Rank Correlation Results across 28 Developing Countries 1992 and 1999

	Export, local content and manufacturing requirements	Employment requirements	Technology targeting
	1992		
FDI stocks, 1992	-0.23	-0.12	0.12
	1999		
FDI stocks, 1999	-0.10	-0.15	0.18
^a According to Table 4. – ^b US-Dollar per capita of the host countries' population.			

Source: Own calculations based on Table 4 and UNCTAD online data base.

These findings seem to strengthen the case of developing countries attempting to improve the “quality” of FDI inflows by insisting on performance requirements. As it seems, the costs of doing so, in terms of a lower quantity of inward FDI, are marginal at most. Before drawing such a conclusion, however, two issues have to be taken into account. First, it is open to debate if (and which) performance requirements actually help improve the “quality” of FDI. Second, there may be other costs involved, notably special incentives granted to foreign investors, which compensate for restrictive performance requirements and, therefore, prevent FDI from falling. These issues are discussed in the remainder of this section.

Performance requirements are designed by host countries to enhance the benefits and minimize the costs of FDI (OECD 2002: 185). For example, local content requirements are regarded as an important means to strengthen economic links between foreign and local producers and, thereby, create local employment opportunities as well as technological spillovers (Kumar 2001). Requirements related to local content, exports and foreign exchange neutrality are intended to reduce the risk that FDI leads to a deterioration of the current account. And mandatory technology transfers may help promote the development of an indigenous industry that is competitive internationally.

Some proponents of performance requirements tend to take it for granted that reasonable development objectives will be achieved in this way (e.g., Kumar 2001; Singh 2001). The detailed account by Moran (1998) of host-country policies to shape foreign investor activities portrays a differentiated picture. In a summary paper, this author draws the following conclusions (Moran 1999): Export performance requirements have encouraged the integration of foreign affiliates into the global operations of their parent companies and have, thus, helped economic development of host countries. By contrast, FDI is found harmful to the growth and welfare of developing host countries when foreign investors are sheltered from competition in the host-country market and burdened with high domestic content, mandatory joint venture and technology-sharing requirements.

Likewise, a recent OECD study provides little comfort to those supposing that performance requirements are generally in the interest of developing countries (OECD 2002: 185 ff.). The relevant literature, summarized in this study, rather suggests that the development impact of performance requirements varies across countries, sectors and motives for FDI. Similar to Moran (1998), the case for export requirements is considered stronger than the case for local content requirements. The former can play a crucial role in pushing multinational enterprises to integrate their affiliates in developing countries more closely into corporate sourcing networks,³² and may counteract the “high incidence of restrictive clauses imposed by MNEs on [the export activities of] their local affiliates” (Kumar 2001: 3153, with regard to India). By contrast, local content requirements tend to protect inefficient local producers. Foreign investors who are forced to use inputs that are not up to world-market standards suffer cost increases and impaired international competitiveness. As a consequence, local content requirements may backfire on export objectives. OECD (2002: 192) concludes that the record for

performance requirements in achieving development objectives is “less than encouraging”. In an earlier survey on the diffusion of technological know-how of foreign investors, Blomström and Kokko (1997) found that local competence and a competitive environment tend to be more important than technology transfer requirements for achieving productivity benefits from FDI.

As concerns the economic costs of performance requirements, incentives granted to foreign investors by host country governments have to be taken into account. If multinational enterprises undertake FDI in spite of performance requirements, this may be because they perceive such requirements as a quid pro quo for compensatory advantages offered by the host country (OECD 2002: 187).³³ Compensatory incentives may have prevented adverse consequences of performance requirements on the quantity of inward FDI, but tend to involve economic costs in terms of allocative distortions and/or budgetary strains. Allocative distortions are likely, if foreign investors are granted privileged access to protected host-country markets and local resources (e.g., raw materials). For example, FDI in various Latin American countries was traditionally concentrated in sophisticated manufacturing industries in which host countries lacked comparative advantage (Nunnenkamp 1997). Import protection supported high rates of return so that the efficiency and international competitiveness of market-seeking FDI was not a major concern of foreign investors (UNCTAD 1998a: 253).

More apparent costs arise when fiscal and financial incentives are granted to foreign investors as a quid pro quo for performance requirements. FDI in the automobile industry of various countries provides a case in point. As noted in OECD (2002: 186 f.), local content requirements are widely used in this industry. At the same time, host country governments incurred huge fiscal or financial costs to attract FDI in the automobile industry. Oman (2001: 69) presents data, gathered from unofficial sources, according to which “the direct cost of financial and fiscal subsidies paid by governments (predominantly sub-national governments) to attract FDI in major automobile factories rose substantially over the course of the 1980s and 1990s, and amounted to hundreds of thousands of dollars per job-to-be-created in countries as diverse as Brazil, Germany, India, Portugal and the United States.”

In conclusion, the issue of performance requirements must not be considered in isolation. Performance requirements are not to be recommended, unless they help achieve development objectives and the direct and indirect costs involved do not exceed the benefits. Incentives-based competition for FDI, an issue to which we turn next, may be particularly perilous for developing countries lacking the financial means to compete successfully with developed countries. All this is underlying the suggestion, e.g. by Moran (1999), that developing countries might offer to refrain from performance requirements in exchange for a commitment of developed countries to refrain from incentives-based competition for FDI.³⁴

7 Incentives-based Competition for FDI

Comprehensive statistics on the use and significance of FDI incentives do not exist. That is why the World Bank (2003: 118) considers it of high priority for international collaboration to systematically compile information on FDI incentives. For obvious reasons, however, neither the governments that offer incentives nor the investors who receive them are willing to disclose the amount of incentives (Oman 2001). Most of the relevant literature on FDI incentives refers to the limited evidence presented by UNCTAD (e.g., Moran 1998; Kumar 2001; Kokko 2002). This evidence allows the following conclusions:

- Major FDI projects involved subsidies amounting to hundreds of thousands of dollars per job-to-be created.
- Both developed and developing countries engaged in incentives-based competition; “bidding wars” frequently involved local and provincial authorities.

- Incentives-based competition has increased considerably since the mid-1980s. More than 100 countries provided various FDI incentives in the mid-1990s. In recent years, few countries appear to have competed for FDI without any form of subsidies.
- Financial incentives are common in developed countries, while incentive schemes in developing countries are often based on tax holidays and other fiscal measures that do not require direct payments of scarce public funds.
- FDI incentives appear to be concentrated in some technologically advanced industries such as automobiles, petrochemicals and electronics.
- Incentive packages are offered particularly for large, “high-visibility” projects.

The economic justification of FDI incentives depends on whether they are (i) effective in increasing the amount of FDI inflows and (ii) efficient in that the costs of providing incentives do not exceed the benefits to the host country.³⁵ The effectiveness of FDI incentives was considered highly questionable by most economists in the past (Oman 2001; Nunnenkamp 2001a). However, Kokko (2002) argues that globalization has made incentives a more important determinant of international investment decisions; this author refers to recent surveys and econometric studies supporting this view.³⁶

The strongest efficiency argument in favor of FDI incentives is based on prospects for economic spillovers. Foreign firms often command over superior technology and knowledge. Local firms may benefit from productivity-enhancing externalities or spillovers, e.g., through forward or backward linkages with foreign firms. Such spillovers do not enter the private cost-benefit calculus of foreign firms. Hence, FDI tends to be less than is optimal from the host country perspective. FDI incentives can bridge the gap between private and social returns. It follows that the efficiency of FDI incentives depends on the significance of spillovers.

The empirical evidence on spillovers is mixed. Kokko (2002: 5) summarizes as follows: “There is strong evidence pointing to the potential for significant spillover benefits from FDI, but also ample evidence indicating that spillovers do not occur automatically.” Hence, the efficiency of FDI incentives is not obvious, and systematic differences between countries are to be expected. Hoekman and Saggi (2000: 638) conclude that “the elusive nature of spillovers makes it difficult to justify the use of investment incentives on the scale they are being used today”.

From a developing country perspective, the efficiency of FDI incentives deserves particular attention, when defining their negotiation stance on multilateral investment rules. Even though the potential for FDI-induced catching-up processes should, in principle, be inversely related to the per-capita income of host countries, it would be wrong to conclude that the efficiency of FDI incentives is highest in low-income countries. The available evidence rather suggests that productivity-enhancing spillovers materialize only if the host country has reached a threshold of sufficient local capabilities to absorb superior technologies and knowledge of foreign investors.³⁷ This implies that FDI incentives amount to a waste of scarce public resources in many poor developing countries.

Especially where FDI incentives are difficult to justify economically, the pervasiveness of incentives is probably largely due to political considerations. FDI incentives are politically attractive: Host country governments can point to visible results of their promotional efforts when an FDI project is attracted by granting incentives, whereas the costs of incentives are typically widely spread and hardly visible. There is, thus, a built-in bias towards offering overly generous incentives. In other words, politically motivated competition for FDI tends to raise incentive levels and shifts benefits from host countries to foreign investors (Haaland and Wooton 1999). It is precisely the lack of transparency which renders incentives-based competition for FDI problematic. Secrecy creates “significant possibilities for graft, corruption and many other types of rent-seeking behaviour” (Oman 2001: 79).

The “race to the top” in offering FDI incentives is difficult to stop, even though the economic case for not taking part in incentives-based competition may be strong. Politically, it may not be feasible to withdraw incentives unilaterally. Even if economic fundamentals of host countries remain a more important pull factor of FDI inflows, incentives can make a difference in an investor's final locational choice among short-listed countries with similarly favorable fundamentals (Oman 2001: 68). Host country authorities, including sub-national governments, find themselves in a prisoner's dilemma when

multinational enterprises start playing the authorities off against each another to bid up the value of incentives. Incentives offered by one particular country may have negative external effects on another country, in terms of either countervailing incentives or forgone FDI inflows.

Policy coordination seems key to escape this dilemma. The scarcity of serious attempts to overcome coordination problems and limit competition for FDI is all the more surprising. As noted by Oman (2001), there is one major exception, namely the European Union, which offers some lessons of how to limit incentives-based competition (Box 4). Developing countries may find the EU approach fairly attractive, as “development areas” are granted preferential treatment. If this principle was applied in multilateral negotiations on incentives-based competition for FDI, developing countries would have more leeway than developed countries to attract FDI by offering incentives.

Box 4

Limiting Incentives-based Competition for FDI: The Example of the EU^a

Since the creation of the European Economic Community in 1957, the European Commission has been empowered to limit the ability of member countries to offer subsidies to firms and investors. The underlying reason was that uncontrolled subsidies could undermine the objective of the Treaty of Rome to achieve a common market and a convergence in living standards across member countries. As a result, a system of “bounded competition” has emerged, in which subsidies are confined by the European Commission to geographically defined lower-income regions (“development areas”). The system may be far from perfect, but it offers:

- a functional regulatory framework,
- an autonomous supervisory body,
- procedures for enforcement, and
- sanctions backed by provisions for judicial review.

The EU model may not be easily copied by other countries, or a larger group of less integrated countries. Nevertheless, it seems worthwhile to study its features in more detail, in order to tackle the prisoner’s dilemma in multilateral negotiations.

^aBased on Oman (2001: 66).

However, a multilateral agreement that seeks to discipline incentives designed to attract FDI “will be difficult to achieve and difficult to enforce, given that governments have multiple instruments at their disposal to attract FDI or to retain investment” (Hoekman and Saggi 2000: 640). The hope of developing countries for an agreement that effectively restrains industrialized countries in providing subsidies to foreign investors may prove illusory. The failure of the MAI among OECD countries is quite telling in this regard (see Section 4).

Furthermore, it is open to question whether developing countries could attract substantially more FDI, without putting too much strain on their financial resources, if only developed countries were restrained in subsidizing FDI. For most FDI projects, developing countries compete with each other, rather than with highly developed countries. Oman (2001: 65) observes that “much of the competition for FDI is effectively among governments in the same geographic region, i.e. among relative neighbours.” Hence, preferential treatment of developing countries with regard to FDI incentives would hardly be instrumental to strengthening the bargaining position of developing host countries in resisting the demand for incentives by multinational enterprises.

Its political attractiveness notwithstanding, preferential treatment along the lines of the EU system would solve only the minor part of the problem. From an economic perspective, developing countries would be well advised to go beyond requests directed at developed countries to reduce their FDI incentives and, thereby, offer developing countries better chances in incentives-based competition. Self-restraint appears to be indispensable, in order to strengthen the bargaining position of developing countries vis-à-vis multinational enterprises. A unilateral withdrawal of incentives is rendered difficult

by the prisoner's dilemma. Unless this dilemma is tackled effectively by a binding multilateral framework, policy coordination at the regional level could be helpful in preventing an incentives race to the top.

8 Conclusions and Strategic Options

Several arguments suggest that multilateral negotiations on an investment agreement should not figure high on the WTO agenda. Investment rules do exist already in BITs, RTAs and even at the multilateral level in TRIMS and GATS. Existing rules may be far from perfect, but it is difficult to conceive that a clearly superior set of rules could be agreed upon under the roof of a WTO agreement on investment.

The most likely outcome of multilateral negotiations on investment will be a "WTO-plus" framework. Any WTO member could move beyond the multilaterally defined smallest common denominator, by concluding more far-reaching agreements either bilaterally or among regional partners. This has an important implication for one of the widely perceived strong-points of a multilateral agreement, the reduction of transaction costs. Whatever the relevance of FDI-related transaction costs might be under current conditions (the available evidence suggests that they are frequently overstated), the complexity of different investment rules and regulations would persist, unless BITs and investment rules in RTAs were replaced by a multilateral agreement. This cannot reasonably be expected from the Doha Round, which may at most mark the starting point of WTO negotiations on investment. Our reasoning is supported by the World Bank (2003: 127–128), which notes that the Doha Ministerial Declaration reflects a rather limited approach that does not view a multilateral framework as a substitute for BITs and RTAs. It is also mentioned in this context that recent negotiating briefs in the WTO indicate that some countries have withdrawn support for investor-state dispute settlement, which would lessen investor protection compared to various bi- and plurilateral agreements. The transaction-cost argument would become close to irrelevant, if developing countries succeeded in preventing strict and generally enforceable rules and insisted on flexibility and "development clauses".

This is not to ignore that Doha could initiate a long-term process towards more substantive and binding multilateral investment rules. Even so, the experience with trade rules suggests that the potential of reductions in transaction costs is easily overstated. Substantial trade liberalization at the multilateral level has not prevented the "spaghetti bowl" of bilateral and plurilateral trade preferences. It is, thus, hardly compelling to argue that, in the course of time, progress with respect to multilateral investment rules will render more and more BITs and RTAs redundant.

The chances to effectively constrain incentives-based competition for FDI do not appear promising either. Even though some economists have questioned the public good character of a multilateral agreement to stop "bidding wars" (e.g., Langhammer 1999; Kumar 2001), policy coordination seems key to escape the prisoner's dilemma. It would be an important first step to develop an inventory of the extent and costs of FDI incentives granted by all WTO members (World Bank 2003). However, due to strong opposition, especially from sub-national authorities, the critical issue of incentives-based competition for FDI had been removed from the agenda of OECD countries even before the attempt to agree on the MAI among themselves failed completely. It seems highly unlikely that developing countries unwilling to tie their own hands can achieve binding concessions from industrialized countries to cut FDI subsidies. Apart from quid pro quo-considerations, the practical consequences of a multilateral agreement would remain limited at best, unless negotiations "enter deeply into the taxation regulations of host countries" (Langhammer 1999: 352) and developing countries were prepared to constrain incentives-based competition among themselves.

Furthermore, our analysis underscores the skeptical view expressed in World Bank (2003: 118) that "new international agreements that focus on establishing protections to investors cannot be predicted to expand markedly the flow of investment to new signatory countries". It is, obviously, difficult to determine, not to speak of predicting, changes in the volume and allocation of FDI resulting from

changes in the regulatory environment. Yet, there are several reasons why the effects of a multilateral agreement on FDI flows to developing countries are likely to fall short of high expectations:

- The absence of such an agreement has not prevented the recent boom of FDI in developing countries.
- Likewise, substantial unilateral liberalization of FDI regulations was undertaken in the past even though multilateral obligations to do so did not exist.
- The coverage of protections to investors in various BITs (and RTAs) goes beyond what can be expected from the Doha Round. Nevertheless, BITs do not appear to have had a significant impact on FDI flows to signatory countries. This can be concluded from several studies applying different methodologies and, thereby, reducing the risk of seriously biased results.
- As shown elsewhere, it is also questionable whether RTAs such as NAFTA and MERCOSUR had a strong and lasting effect on FDI flows to developing member countries (Nunnenkamp 2001b).

It is against this backdrop that developing countries have to decide on their negotiation strategy when it comes to investment-related issues in the current WTO round. Harsh critics of a multilateral agreement on investment, e.g., Kumar (2001) and Singh (2001), urge developing countries to take a firmly defensive stance. Accordingly, resisting the efforts of industrialized countries to go beyond TRIMS is considered the first-best option for developing countries. As a fall-back position, Kumar (2001) suggests to minimize developing countries' own commitments (e.g., by excluding pre-entry rules, and by insisting on development clauses and exceptions from national treatment even in the post-entry phase) and, at the same time, to stick to demands for binding corporate obligations and restraints on FDI subsidies granted by industrialized countries.

The rationale underlying this defensive strategy appears to be that essentially nothing will change if a large enough number of developing countries follows this route. Developing countries and industrialized countries would block each other. To the extent possible under current conditions, the former could still pursue flexible FDI policies deemed necessary to achieve developmental objectives. The latter could take this as an "excuse" for not offering concessions as to the demands of developing countries.

Whether a defensive stance is the appropriate strategy for developing countries depends on two factors: (i) the costs of giving up flexible FDI policies, and (ii) the benefits to be derived from possible concessions by industrialized countries. As concerns the former, the proponents of a defensive strategy tend to ignore that the record of governments in developing countries to promote economic development by flexible and selective FDI policies is mixed at best (see Sections 5 and 6). Moreover, as argued by Hoekman and Saggi (2000: 637), "if a country pursues free trade, a restrictive FDI policy will not transfer any rents as foreign firms will not engage in FDI. Instead, they will contest the market through exports." Hence, the costs of giving up discretion are frequently overstated.

This leads us to suggest an offensive strategy, even though we consider the economic case for a multilateral investment agreement to be weak. Developing countries may offer in multilateral negotiations not to impose any new performance requirements and phase out existing ones. The available evidence on the effectiveness of performance requirements (see Section 6) reveals that developing countries have little to lose if they offered to refrain from joint-venture and technology-sharing requirements, which are not included in the illustrative list of the TRIMS agreement. Financially, they may even gain as compensatory incentives, granted to foreign investors in conjunction with performance requirements, could be abolished.

The WTO may be used as a scapegoat for such a move and may, thus, help overcome the opposition of rent-seeking constituencies within developing countries. By offering something on their own, developing countries will become more relevant negotiation partners for industrialized countries. Only then could developing countries reasonably expect industrialized countries to make concessions as a *quid pro quo*. Concessions by industrialized countries may comprise: the relaxation of rules of origin applied by the EU and NAFTA, which create similar distortions as local-content requirements of developing countries; the inclusion of corporate obligations into a multilateral agreement; and restraints on the use of FDI incentives.

The proposal for developing countries to enter into a “grand bargain” (Moran 1998; 1999) with industrialized countries has been criticized for two reasons by Hoekman and Saggi (2000):

- Given the limited use of existing agreements (notably TRIMS), these authors question the marginal value of yet another multilateral agreement. However, TRIMS is widely considered to be biased against the interests of developing countries. Hence, it may be politically more attractive to developing countries to strive for a more balanced agreement by making a fresh start in negotiating on investment.
- Devising a grand bargain may prove a two-edged sword for developing countries. The potential downside can be seen in cross-issue linkage in areas such as labor standards and the environment, pushed by industrialized countries and civil-society organizations. Yet, Hoekman and Saggi (2000) agree that the grand-bargain argument is one of the *raison d'être* of the WTO. Hence, the question for developing countries is not whether to offer anything, but what to offer and what to demand as a *quid pro quo*.

The offensive strategy outlined so far is rather narrowly defined, as cross-issue linkages are confined to FDI-related policies. Developing countries may be well advised to look beyond negotiations on investment, especially when it comes to concessions demanded from industrialized countries. Concessions from industrialized countries would be easier to achieve, if developing countries made additional offers related to trade under existing agreements, i.e. GATT and GATS (Hoekman and Saggi 2000). Yet, rules-based FDI policies are an important negotiating chip for developing countries. Far-reaching offers related to FDI policies would render it increasingly difficult for industrialized countries to block negotiations in other areas that are of vital interest to developing countries.

Linking national treatment of foreign investors in the pre-entry stage with cross-border movements of workers is an obvious case in point. At present, the request of industrialized countries for an agreement on investment is frequently rejected as it would result in an asymmetry, unless free capital movement is matched by free labor mobility (e.g., Kumar 2001 and Panagariya 2000, quoted in Kumar). However, developing countries should consider the option to transform this defensive stance into an offensive strategy by presenting national treatment in the pre-entry stage as a carrot for industrialized countries to engage in negotiations on labor mobility. Economically speaking, the arguments for labor mobility are no weaker than those for capital mobility (Hoekman and Saggi 2000). The political resistance by industrialized countries to treat labor and capital symmetrically may weaken in the longer run at least, when demographic problems mount in various industrialized countries.

Finally, it is for political-economy reasons that we prefer a broadly defined offensive strategy of developing countries over the currently prevailing defensive stance. As argued in Section 5.1, the cost-benefit calculus with respect to a multilateral investment agreement differs across developing countries, e.g., depending on what FDI has to offer under different host-country conditions. This implies that a united front of developing countries against such an agreement is rather unlikely.

Furthermore, various developing countries may have little choice but to join a multilateral agreement on investment eventually. Some developing countries with large markets and strong economic fundamentals could possibly afford to remain outsiders. But small and less attractive countries probably cannot, even though a multilateral agreement may not induce more or higher-quality FDI inflows. The reason is similar to what UNCTAD (1998a) observed with regard to national FDI regulations: Not taking part in the trend towards more liberal FDI policies can effectively close the door to FDI, whereas liberal FDI policies (or agreeing to a multilateral agreement on investment, for that matter) are just a necessary condition for FDI to help achieve national development objectives.

Conflicting interests among developing countries strengthen the bargaining position of industrialized countries. A purely defensive strategy, as suggested by Kumar (2001) and Singh (2001), is thus likely to fail. Rather than engaging in a futile attempt to block multilateral negotiations on investment altogether, it appears more promising to us to actively take part in negotiations, by making own offers and demanding *quid pro quo*-concessions from industrialized countries.

Annex

Transaction Cost-Related FDI Impediments and Inward FDI: Robustness of Correlation Results

The robustness of correlation results presented in Table 3 in Section 5.3 may be questioned on two grounds:³⁸

- Transaction costs might become an issue only if, in their absence, investors wished to invest in a developing country. In other words, our correlation results for the overall sample may understate the relevance of transaction costs due to the inclusion of developing countries in which reasonable profit opportunities do not exist so that FDI will not take place even if transaction costs are low.
- The relevance of transaction costs may differ between different types of FDI. Most notably, transaction cost-related variables may have varying effects on greenfield investments on the one hand, and mergers and acquisitions (M&As) on the other hand.

The first argument suggests to re-run the correlations for a reduced sample. We excluded six (out of 28) countries, namely Bangladesh, Ghana, Iran, Kenya, Syria and Zimbabwe. The assumption that, due to more fundamental bottlenecks to FDI, transaction costs are more or less irrelevant there is based on two criteria met by these six sample countries: Per-capita FDI stocks in 1999 were extremely small (below US-Dollar 100)³⁹ **and** their share in FDI stocks in all developing countries was below 0.2 percent.

Spearman rank correlations did turn out to be somewhat stronger for the reduced sample (Annex Table 1). Yet, the results deviate surprisingly little between the full and the reduced sample. None of the correlations lacking significance at conventional levels for the full sample becomes significant when the above mentioned countries are excluded. This applies to correlations with both, FDI stocks in 1999 and FDI flows in 1997–2000. This corroborates the finding that transaction costs were a minor factor shaping the distribution of FDI among developing countries. This conclusion holds even for those developing countries for which transaction costs could be expected to play a more important role.

Annex Table 1: Transaction Cost-Related FDI Impediments and Inward FDI: Correlation Results for Full and Reduced Sample^a

FDI impediments ^b	FDI stocks in 1999		FDI flows in 1997–2000	
	full sample	reduced sample	full sample	reduced sample
administrative bottlenecks	–0.53***	–0.64***	–0.39**	–0.49**
entry restrictions	–0.09	–0.05	–0.01	–0.05
post-entry restrictions	–0.01	–0.21	0.04	–0.11
risk factors	–0.62***	–0.76***	–0.54***	–0.64***
technology-related regulations	–0.01	–0.27	0.02	–0.11

*, **, *** significant at 10 percent, 5 percent and 1 percent level, respectively (two tailed).

^a For reasons given in text, we excluded Bangladesh, Ghana, Iran, Kenya, Syria and Zimbabwe. Spearman rank correlation coefficients; inward FDI in US-Dollar per capita of the sample countries' population. – ^b As of 1999 for correlations with FDI stocks; as of 1996 for correlations with FDI flows.

Source: Own calculations on the basis of UNCTAD online data base and ERT (2000).

The second argument calls for a disaggregation of overall FDI inflows. We separated greenfield investment from M&As by subtracting M&A sales, as given in UNCTAD (2002: Annex Table B.7), from total FDI inflows.⁴⁰ Spearman rank correlations are reported in Annex Table 2. As before with

regard to sample selection, the disaggregation of FDI inflows has some impact on the correlation results, but all major conclusions drawn in Section 5.3 remain valid. Entry restrictions appear to have discouraged M&As more than greenfield investment, even though the correlation coefficient turns out to be insignificant for both types of FDI inflows. In all other respects, the correlation exercise reveals only minor differences between M&As and greenfield investment. The two transaction cost-related factors that were negatively correlated with total FDI inflows in a significant way (administrative bottlenecks and risk factors) affected M&As and greenfield investment to the same extent.

Annex Table 2: Greenfield Investment vs. M&As: Spearman Rank Correlations with Transaction Cost-Related FDI Impediments

FDI impediments ^a	FDI flows in 1997–2000 ^b		
	total	M&As ^c	greenfield ^{c,d}
administrative bottlenecks	–0.39**	–0.43**	–0.41**
entry restrictions	–0.01	–0.29	0.16
post-entry restrictions	0.04	–0.07	0.14
risk factors	–0.54***	–0.48**	–0.48**
technology-related regulations	0.02	–0.01	0.15

*, **, *** significant at 10 percent, 5 percent and 1 percent level, respectively (two tailed).

^a As of 1996. – ^b US-Dollar per capita of the sample countries' population. – ^c Excluding Iran due to missing data. – ^d Approximated by the difference between total FDI inflows and M&A sales.

Source: Own calculations on the basis of UNCTAD (2002 and online FDI data base) and ERT (2000).

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Footnotes

- 1 For a summary of the relevant literature, see Nunnenkamp (2002: Section 9).
- 2 In 2001, all regulatory changes which favored FDI (total of 208) were grouped as follows (UNCTAD 2002: 8): more guarantees (24 percent), more liberal entry and operational conditions (28 percent), sectoral liberalization (23 percent), and more promotion including incentives (26 percent).
- 3 We owe this argument to an anonymous referee.
- 4 The World Bank (2003: 127) notes: "The negotiating asymmetries that are common to bilateral agreements have led to treaties in which developing countries have taken on substantive obligations without any reciprocity other than the promise of increases in future private investment."
- 5 FTAA negotiations involve 34 developing countries of Latin America and the West Indies. The United States and Canada are the only developed countries taking part.
- 6 India and China are also now attempting to enter into a free trade agreement with ASEAN.
- 7 The accession to NAFTA by Mexico was due to the expected significant investment and trade benefits which would accrue (Krueger 2000). It has been argued that Mexico was able to overcome one decade of opposition to NAFTA due to the debt crisis of the 1980s, its extreme trade dependence on the United States and its semi-authoritarian regime prior to 1991 (Schirm 2002). In addition, the formation of NAFTA was propelled by Mexico's GATT membership since 1986 and fears of a "Fortress Europe".
- 8 The framework for a binational judicial review of tribunal decisions is laid down in Chapter 19 of the NAFTA Treaty.
- 9 However, as mentioned before, pressure by the United States played a role in NAFTA and may also shape investment rules in FTAA.
- 10 According to Rugman and Anderson (1997), however, the NAFTA dispute settlement mechanism was running into problems.
- 11 Performance requirements are also covered in some BITs involving Canada, Japan and Mexico.
- 12 We owe this argument to an anonymous referee.
- 13 See, for example, the summary of discussions with regard to trade and investment in DSE Forum (2002: 39 ff.).
- 14 For a summary of relevant studies, see Nunnenkamp (2002).
- 15 The so-called spaghetti bowl of trade preferences (Bhagwati) clearly suggests that such an outcome would be sub-optimal from an economic point of view. Yet, for political-economy reasons, we consider it unlikely that a multilateral agreement on investment will achieve what proved impossible so far in trade negotiations.
- 16 The small sample of 28 countries may compromise the representativeness of survey results for the developing world. Note, however, that the sample accounted for 62 percent of FDI flows to all developing countries in 1997–2000 (UNCTAD online data base).
- 17 The business community may have had incomplete information on unilateral liberalization in the past. Improved information could then contribute to a fading interest of the private sector in a multilateral agreement. On the other hand, the business community may still consider a multilateral agreement to be the best means to lock in previous unilateral liberalization measures, i.e. render them irreversible.
- 18 The remainder of this section draws on Nunnenkamp and Spatz (2002).
- 19 Both, FDI stocks and flows are considered in US-Dollar per capita of the sample countries' population in the correlation analysis. In this way, we avoid the large-country bias that characterizes the distribution of FDI in absolute terms.
- 20 The robustness of results was checked in two respects; see Annex for details.
- 21 It is for two reasons that we ran separate regressions for each index with the same controlling variables. First, the indices on FDI impediments reveal a fairly high degree of multicollinearity. Second, we retain more degrees of freedom in this way.
- 22 These results are not shown here in order to save space.
- 23 For an evaluation of mandatory technology transfers and other performance requirements, see Section 6.

- 24 Special treatment of developing countries was codified in GATT through the so-called Part IV Extension in 1965 and the Enabling Clause on "Differential and More Favorable Treatment, Reciprocity and Fuller Participation of Developing Countries" in 1979.
- 25 See also Langhammer (1999) and the literature given there.
- 26 See also Section 6 on performance requirements.
- 27 We owe this point to Alan Winters.
- 28 Note that performance requirements related to exports etc. constituted one element of post-entry restrictions considered in Section 5.3; technology targeting constituted one element of technology-related regulations (see Box 3 for details).
- 29 The score improved (i.e., declined) in 43 out of 84 entries in Table 4; it remained constant in 38 cases.
- 30 FDI stocks are considered in per-capita terms, in order to control for country size; further details can be found in Nunnenkamp and Spatz (2002).
- 31 This unexpected result is mainly because Malaysia reported the highest inward FDI stock per capita in 1999 (US-Dollar 2234) among all sample countries, even though it was rated most unfavorably in Table 4 with regard to technology targeting in 1999.
- 32 This remains unlikely, however, if the host country pursues trade policies giving rise to a strong anti-export bias.
- 33 According to Hoekman and Saggi (2000: 630), "the schizophrenic nature of the overall policy environment" is reflected in that FDI incentives are granted in conjunction with performance requirements.
- 34 See Section 8 for a discussion of strategic options of developing countries.
- 35 The subsequent discussion draws on Kokko (2002) and the literature given there.
- 36 As noted earlier in the context of BITs (Section 2) and transaction costs (Section 5.3), it is difficult to determine what the allocation of FDI would have been in the absence of one particular element of the regulatory framework governing FDI. This is particularly so when it comes to FDI incentives for which there is a serious lack of data.
- 37 For an overview of the relevant literature in this regard, see Nunnenkamp (2002).
- 38 We owe the following arguments to T.N. Srinivasan and Simon Evenett.
- 39 The average for all 28 sample countries amounted to almost US-Dollar 500.
- 40 Note that this results in an imperfect proxy of greenfield investment since the data sets on total FDI flows and M&As are not consistent with each other.